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Law and Economics

by Paul H. Rubin
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"Law and economics," also known as the economic analysis of law, differs from other forms of legal analysis in two main ways. First, the theoretical analysis focuses on **EFFICIENCY**. In simple terms, a legal situation is said to be efficient if a right is given to the party who would be willing to pay the most for it. There are two distinct theories of legal efficiency, and law and economics scholars support arguments based on both. The positive theory of legal efficiency states that the common law (judge-made law, the main body of law in England and its former colonies, including the United States) is efficient, while the normative theory is that the law *should be* efficient. It is important that the two theories remain separate. Most economists accept both.

Law and economics stresses that markets are more efficient than courts. When possible, the legal system, according to the positive theory, will force a transaction into the market. When this is impossible, the legal system attempts to "mimic a market" and guess at what the parties would have desired if markets had been feasible.

The second characteristic of law and economics is its emphasis on incentives and people's responses to these incentives. For example, the purpose of damage payments in accident (tort) law is not to compensate injured parties, but rather to provide an incentive for potential injurers to take efficient (cost-justified) precautions to avoid causing the accident. Law and economics shares with other branches of economics the assumption that individuals are rational and respond to incentives. When penalties for an action increase, people will undertake less of that action. Law and economics is more likely than other branches of legal analysis to use empirical or statistical methods to measure these responses to incentives.

The private legal system must perform three functions, all related to property and **PROPERTY RIGHTS**. First, the system must define property rights; this is the task of property law itself. Second, the system must allow for transfer of property; this is the role of contract law. Finally, the system must protect property rights; this is the function of tort law and criminal law. These are the major issues studied in law and economics. Law and economics scholars also apply the tools of economics, such as **GAME THEORY**, to purely legal questions, such as various parties' litigation strategies. While these are aspects of law and economics, they are of more interest to legal scholars than to students of the economy.

History and Significance

Modern law and economics dates from about 1960, when **RONALD COASE** (who later received a Nobel Prize) published "The Problem of Social Cost." Gordon Tullock and **FRIEDRICH HAYEK** also wrote in the area, but the expansion of the field began with **GARY BECKER**'s 1968 paper on crime (Becker also received a Nobel Prize). In 1972, Richard Posner, a law and economics scholar and the major advocate of the positive

theory of efficiency, published the first edition of *Economic Analysis of Law* and founded the *Journal of Legal Studies,* both important events in the creation of the field as a thriving scholarly discipline. Posner went on to become a federal judge while remaining a prolific scholar. An important factor leading to the spread of law and economics in the 1970s was a series of seminars and law courses for economists and economics courses for lawyers, organized by Henry Manne and funded, in part, by the Liberty Fund.

The discipline is now well established, with eight associations, including the American, Canadian, and European law and economics associations, and several journals.[1] Law and economics articles also appear regularly in the major economics journals, and the approach is common in law review articles. Most law schools have faculty trained in economics, and most offer law and economics courses. Many economics departments also teach courses in the field. A course in law and economics is very useful for undergraduates contemplating law school. Several consulting firms specialize in providing economic expertise in litigation.

Substance

Property

A legal system should provide clear definitions of property rights. That is, for any asset, it is important that parties be able to determine unambiguously who owns the asset and exactly what set of rights this ownership entails. Ideally, efficiency implies that, in a dispute regarding the ownership of a right, the right should go to the party who values it the most. But if exchanges of rights are allowed, the efficiency of the initial allocation is of secondary importance. The Coase theorem—the most fundamental result in the economic study of law—states that if rights are transferable and if transactions costs are not too large, then the exact definition of property rights is not important because parties can trade rights, and rights will move to their highest-valued uses (see **EXTERNALITIES**).

In many circumstances, however, who owns the right will matter. Transactions costs are never zero, and so if rights are incorrectly allocated, a costly transaction will be needed to correct this misallocation. If transactions costs are greater than the increase in value from moving the resource to the efficient owner, there may be no corrective mechanism. This can happen in any sort of economy. An extreme example is Russia, where the courts have not been able to provide clear definitions of property rights, and those persons with control of firms are not necessarily the owners. That is, those with control over a firm cannot sell it and keep the proceeds. This creates incentives for inefficient use of the assets, such as sale of valuable raw materials for below-market prices, with the proceeds deposited outside the country. In such circumstances, the Coase theorem will not operate, and correctly defining property rights becomes important. More generally, experience in Russia and its former satellites has emphasized the importance of the legal system for development of a market economy and, thus, has shown the importance of law and economics in influencing policy.

One important finding of law and economics is that, in market economies, property rights are defined efficiently in many circumstances. The characteristics of efficient property rights are universality (everything is owned), exclusivity (everything is owned by one agent), and transferability. Law and economics can also explain the results of inefficient property definitions. For example, because no one owns wild fish, the only way to own a fish is to catch it. The result is overfishing (see **TRAGEDY**

OF THE COMMONS). **INTELLECTUAL PROPERTY** is an important area of current research because new copying and duplicating technologies are having profound effects on the definition of this form of property rights and on incentives for creating such property.

Contract Law

The law governing exchange is crucial for a market economy. Most of the doctrines of contract law seem consistent with economic efficiency. Law and economics study of contract law has shown that, in general, it is efficient for parties to be allowed to write their own contracts, and under normal circumstances, for courts to enforce the agreed-on terms, including the agreed-on price. The courts will generally not enforce contracts if performance would be inefficient, but, rather, will allow payment of damages. If, for example, I agree to build something for you in return for $50,000, but meanwhile costs increase so that the thing would cost me $150,000 to build, it is inefficient for me to build it. Courts, recognizing this, allow me to compensate you with a monetary payment instead. This is efficient.

Contracts and contract law are also designed to minimize problems of opportunism. The danger of opportunism arises when two parties agree to something, and one makes irreversible investments to carry out his side of the bargain. So, for example, a company invests in a railroad spur to a coal mine, making a contract in advance to ship the coal at a specific price. Once the railroad is built, the mine owner can refuse to honor his contract and can hold out for a lower shipping rate. As long as this rate exceeds the railroad's incremental costs, the railroad owner will be tempted to accept. If he does so, he will not receive the full return on the spur line that he needed to make the **INVESTMENT** worthwhile. Doctrines such as a duty to mitigate (to reduce the harmful effects of breach of contract) are easily explained as being efficient.

However, not all doctrines are efficient. Contracting parties will sometimes specify damages (called "liquidated damages") to be paid if there is a breach. If the courts decide that these liquidated damages are too high—that they are a penalty rather than true damages—they will not enforce the amount of contractual liquidated damages. This failure to enforce agreed-on terms is a major puzzle to law and economics scholars; it appears that the courts would do better to enforce the parties' agreement, just as they do with respect to price and other terms of a contract. Here, the positive theory of the efficiency of law seems to be violated, but scholars argue that the courts should enforce these agreements.

Tort Law

Tort law and criminal law protect property rights from intentional or unintentional harm. The primary purpose of these laws is to induce potential tortfeasors (those who cause torts, or accidents) or criminals to internalize—that is, take account of—the external costs of their actions, although criminal law has other functions as well.

Tort law is part of the system of private law and is enforced through private actions. The economic analysis of tort law has stressed issues such as the distinction between negligence (a party must pay for harms only when the party failed to take adequate or efficient precautions) and strict **LIABILITY** (a party must pay for any injury caused by its actions). Because most accidents are caused by a joint action of injurer and victim (a driver goes too fast, and the pedestrian he hits does not look carefully), efficient rules create incentives for both parties to

take care; most negligence rules (negligence, negligence with a **DEFENSE** of contributory negligence, comparative negligence) create exactly these incentives. Strict liability is important when the issue is not only the care used in undertaking the activity, but also whether the activity is done at all and the extent to which it is done (the level of the activity); highly dangerous activities (e.g., blasting with explosives or keeping wild animals as pets) are generally governed by strict liability.

Tort law used to be uninteresting and unimportant, dealing largely with automobile accidents. But it has become quite important in the United States in the last fifty years, because many events traditionally treated under contract law are now subject to tort law. For example, in products liability and medical malpractice cases, the parties have a preaccident relationship and so could have specified and traditionally did specify in their contracts what damages would be paid in the event of a mishap. But since about 1950, the courts have refused to honor these contracts, treating these instead as tort cases. Many observers believe that this was a fundamental error of the courts and look on it as the primary example of an inefficient doctrine in modern American law. Scholars have found that this error was caused by actions on the part of the plaintiff's bar, who were seeking to benefit themselves at the expense of the public in general. Problems are exacerbated when claims are aggregated through the mechanism of class actions.

Two factors have caused the major expansion of product liability law. One was finding relatively strict liability for "design defects" in addition to "manufacturing defects." The other was expansion of liability for "failure to warn." One result of treating these events as part of tort law is that injured parties can collect classes of damage payments (such as damages for pain and suffering and sometimes excessive punitive damages) that would be excluded by contract if contracts could be enforced. As a result, prices of many goods and services (including medical services) are driven above the value that consumers would place on them. That is why, for example, private airplanes are so expensive, and obstetricians and gynecologists are unavailable in some markets.

Criminal Law

Criminal law is enforced by the state rather than by victims. This is because efficient enforcement requires that only a fraction of criminals be caught (in order to conserve on enforcement resources) and the punishment of this fraction be multiplied to reflect the low probability of detection and conviction. If, for example, only one out of four criminals is caught and punished, then the punishment must be four times the cost of the crime in order to provide adequate deterrence.

However, most criminals do not have sufficient wealth to pay such multiplied fines, and so incarceration or other forms of nonpecuniary punishment must be used. One implication of law and economics is that a fine should be used as punishment whenever the miscreant can pay. The reason is that fines are transfers and do not create deadweight losses (i.e., losses to some that are not gains to others); imprisonment, on the other hand, transfers virtually no wealth from the criminal but causes two forms of deadweight loss: the loss of the criminal's earning power in a legitimate job in the outside world and the cost to taxpayers of providing a prison and guards. But because so few criminals have enough wealth to pay multiplied fines, private enforcement would not be profitable for private enforcers, and so the state provides enforcement. In some circumstances, incarceration serves the additional function of incapacitation of potential wrongdoers.

Criminal law has been the subject of the most extensive empirical work in law and economics, probably because of the availability of data (see **CRIME**). Economic theory predicts that criminals, like others, respond to incentives, and there is unambiguous evidence that increases in the probability and severity of punishment in a jurisdiction lead to reduced levels of crime in that jurisdiction. The issue of the deterrent effect of capital punishment has been more controversial, but several recent papers using advanced econometric techniques and comprehensive data have found a significant deterrent effect; each execution deters between eight and twenty-eight murders, with eighteen being the best single estimate. No refereed empirical criticism of these papers has been published. Research on procedural rules has shown that increased rights for accused persons can lead to increases in crime. One controversial paper by John Donohue and Steven Levitt argues empirically that the easing of abortion restrictions led to a reduction in crime because unwanted children would have been more likely to become criminals. There are also major debates in the literature on the effect on crime of laws allowing easier carrying of concealed weapons. Some, such as John Lott, find significant decreases in crime from these laws, while others find much smaller effects, although there is little evidence of any increase in crime.

About the Author

Paul H. Rubin is Samuel Candler Dobbs Professor of Economics and Law at Emory University in Atlanta and editor in chief of *Managerial and Decision Economics.* Dr. Rubin was a senior staff economist with President Ronald Reagan's Council of Economic Advisers, chief economist with the U.S. Consumer Product Safety Commission, and director of Advertising Economics at the Federal Trade Commission.

Further Reading

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Footnotes

1. Including: *Journal of Law and Economics; Journal of Legal Studies; Journal of Law, Economics and Organization; American Law and Economics Review; International Review of Law and Economics; Supreme Court Economic Review; Research in Law and Economics; European Journal of Law and Economics.* Articles in the field are also available online at: **http://ssrn.com/ and http://law.bepress.com/repository/**. On the American Law and Economics Association, see: **http://www.amlecon.org/**.

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