

Economic Theory of Law

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Summary: This article describes the chronology of the birth of one of the important concepts in neo-institutionalism – the economic theory of law. This is a science that rests on the border between economics and law, and is now taught in economics and law faculties of the most famous universities in the world. The following aspects have been considered: the main stages of its formation, fundamental papers tracing its development, key figures (R. Coase, G. Calabresi, D. Becker, R. Posner) that have played an important role in the formulation of its fundamental principles, the system of laws and categories that now form the body of its toolkit. The article defends the thesis that it is now pressing for this relatively new scientific discipline to find a place in Bulgarian higher education too.

Keywords: **economics** and law, economic theory of law, rights of ownership, transaction costs, economic imperialism, economic approach to crime, law and economic efficiency, effectiveness and fairness.

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The so-called **Economic Theory of Law** (also known as Economics of Law) constitutes a special section of neo-

institutional theory, and split off as a separate subject in the mid-60's of the 20th century. This concept lies on the boundary between economic theory and law. The initial studies, which laid the foundations of the modern economic theory of law, are believed to be the articles (prepared independently of one another) by **Ronald Coase: "The Problem of Social Cost"** (*Journal of Law and Economics*, 1, 1960), and by **Guido Calabresi: "Some Thoughts on Risk Distribution and the Law of Torts"** (*Yale Law Journal*, 70, 1961).

The first of these articles is devoted to the general system of studying the relationships between ownership and responsibility in the terms and categories of economic theory. **The second** article discusses the economic analysis of accident liability.

At first glance, the famous article by R. Coase "**The Problem of Social Cost**" is not about legal issues – no legal principles are considered. However, its significance with respect to discovering the possibility of applying an economic approach to law is indisputable, according to V. L. Tambovtsev¹, because it contained *the first formulation of a general approach to the interpretation of any legal system*. Coase believes that the necessity of a legal system in society stems from the fact that transaction costs are not equal to zero.

In his lecture, at the bestowal of the 1991 Nobel Prize in Economics, he said, "If we move from a regime of zero transaction costs to one

¹ Тамбовцев, В. Л., от редактора В. кн. на Р. Познер – Экономический анализ права: В 2-х т. /Пер. с англ. Под ред. В. Л. Тамбовцева. СПб.: Экономическая школа, 2004. Т. 1, с. XI.

of positive transaction costs, what becomes immediately clear is the crucial importance of the legal system in this new world. I explained in *The Problem of Social Cost* that what are traded on the market are not, as is often supposed by economists, physical entities but the rights to perform certain actions and the rights which individuals possess are established by the legal system. While we can imagine in the hypothetical world of zero transaction costs that the parties to an exchange would negotiate to change any provision of the law which prevents them from taking whatever steps are required to increase the value of production, in the real world of positive transaction costs such a procedure would be extremely costly, and would make unprofitable, even where it was allowed, a great deal of such contracting around the law. Because of this, the rights which individuals possess, with their duties and privileges, will be, to a large extent what the law determines. As a result the legal system will have a profound effect on the working of the economic system and may in certain respects be said to control it².

The neoclassical interpretation of the Coase Theorem, constituting one of the fundamentals of the economic analysis of law, views it as a model of a dispute between two individuals or between two companies regarding the establishment of a legal principle, i.e. in the exact way the dispute, which creates similar situations when court rulings are made in the system of common law, is construed. **Such parallels have very deep grounding:** researchers working in the field of economic analysis of law often postulate that *the institutions of common law, aimed at creating private solutions agreed through litigation, in themselves represent an aspect of the market*³.

A dispute between parties regarding the use of some or other proprietary rights really does create a situation of negotiation or market transaction where, theoretically, *agreement on the solution can be found by the parties themselves without recourse to third parties* (court, arbitration, government, etc.) However, in some circumstances, the high cost of making such a deal necessitates that the parties turn to the legal institutions, which essentially carry out the function of the market by perfecting the transaction.

R. Coase can be credited with proving that, in the absence of transaction costs, the result of bargaining between parties will be such a reallocation of rights that will be efficient and, at the same time, independent of the legal rules underlying such rights. On the contrary, *positive transaction costs, which impede bargaining and making mutually beneficial deals, result in the rules becoming an important factor in public development*. Thus, from an economic perspective, the role of the court is reduced to being a substitute to a market with zero transaction costs – one that does not exist in real life.

The article by G. Calabresi demonstrates that in the long-term the consequence of changing the rules of liability must be a continued investment in those areas of activity where the employer is exempt from liability, and termination of investment in those fields where the employer, by contrast, is held liable. This means a legal precedent or principle defining who exactly – worker or employer – is liable for a certain accident, and under what conditions and in what areas of activity does such precedent or principle apply.

² Коуз, Р., Нобелевская лекция “Институциональная структура производства” (1991) В кн. Природа фирмы: Пер. с англ. – М.: Дело, 2001, с. 348.

³ Тамбовцев, В. Л., от редактора В кн. на Р. Познер – Экономический анализ права: В 2-х т. /Пер. с англ. Под ред. В. Л. Тамбовцева. СПб.: Экономическая школа, 2004. Т. 1, с. XII.

The importance of the works of Coase and Calabresi, opines the Russian scientist V. L. Tambovtsev⁴, lies in the fact that **their economic approach is applied to legal institutions as a whole**, i.e. to law as a social institution. To put it another way, economic concepts and models have started to be applied **beyond the confines of economics** as a field of the rational actions of individuals in the allocation and use of limited resources.

Nobel Laureate **Gary Becker**, with his economic analysis of nonmarket forms of behaviour, in particular crime, also made important contributions to the formation and development of the economic theory of law. The seminal paper on this subject is **Crime and Punishment: An Economic Approach** (Becker, G. // Journal of Political Economy, 1968, v. 76, n. 1, p. 169-217). By significantly expanding the range in which the economic approach is applied to the study of social phenomena, he became the founder of the offshoot that is referred to as "**economic imperialism**". His followers actively "took over" traditionally non-economic areas of analysis, such as crime, racial discrimination, education, politics, demographic production, marriage, family planning, home economics, etc.

The prevailing opinion among scientists, especially psychologists and sociologists, is that criminals are either mentally ill people, or passive victims of an adverse social environment. Their behaviour is determined by exogenous factors, biological or social, over which they have no control. G. Becker's approach is radically different – to him *criminals are rational agents* who react in a predictable manner to existing opportunities and constraints. They also strive to maximise the expected benefit and, from this

perspective, their behaviour is indistinguishable from the behaviour of others⁵.

He considers the choice of a criminal career as a normal investment decision under conditions of risk and uncertainty. Therefore, the seriousness of the crime must depend on the ratio between costs and benefits it respectively incurs and brings.

The benefits obtained by criminals are determined by the difference between income from illegal and legal activities. This explains why the propensity to commit offenses such as theft or robbery is characteristic mainly of people that come from poor families, the unemployed or low-educated people. Thus, criminal behaviour turns out to be closely related to earlier investments in human capital, such as level of education and training.

If we consider **the cost of carrying out a criminal activity**, then its main component is based on the prospect of punishment. This is the "price" that a criminal must pay for his career choice in case of failure. *The economic approach assumes that the demand for crime is elastic with respect to price*, hence criminals tend to react predictably to changes in the price. All other things being equal, the more likely it is for someone to get caught and receive harsh punishment, the higher the costs of crime and the less attractive the incentives to engage in it would be; therefore, the number of criminals would decrease.

The economic approach to crime, developed by G. Becker, has gained great popularity and is starting to be used in the analysis of disparate sections of legislation, and what is more, even in court rulings.

⁴ Пак там, с. XIII.

⁵ Капелюшников, Р. И., Послесловие. Вклад Гэри Беккера в экономическую теорию в кн. на Г. С. Беккер – Человеческое поведение: экономический подход. Избранные труды по экономической теории: Пер. с англ. /Сост., науч. ред., послесл. Р. И. Капелюшникова; предисл. М. И. Левин. – М.: ГУ ВШЭ, 2003, с. 654-656.

The universally acknowledged classicist of the modern economic theory of law is American jurist **Richard Posner**, a prominent figure in the recently expanding movement to introduce economic theory in the syllabuses of law faculties and conduct real-life economic analysis of the causes and consequences of the legal system.

R. Posner wrote the fundamental paper "**Economic Analysis of Law**" (Posner, R. A., Little, Brown, 1973). In it, he proves that the economic approach can be productively applied to virtually all areas of law. His work has at least three important merits:

First, it is encyclopaedic in nature, because it presents the main results obtained from research into the economic theory of law.

Second, this was the *first textbook on economic theory intended not for economists, but for jurists*. Thus, the discipline of "law and economic theory" became a fully recognised and organic part in the syllabuses of students of economics and law faculties.

Third, the publication of this work helped to conclusively and accurately define the subject and method of the economic theory of law, which thereby became a fully-fledged, self-developing scientific discipline, occupying an important place in neo-institutional theory.

As is known from the writings of R. Coase, nonmarket methods of organisation of economic activity emerge when the transaction costs (of ideal deals) are too high for a normal market exchange – both the company and the legal system replace the market only in a case where market transactions are impossible. But given that in the majority of cases market transactions are voluntary, social welfare increases because

such a transaction simply would not take place unless it is advantageous to all parties to it. *The question that Posner asks himself is, "Do transactions conducted via the courts have similar properties?"*

A distinctive feature of Posner's papers "**Economic Analysis of Law**", "**Antitrust Law: An Economic Perspective**" (Posner, R., University of Chicago Press, 1976) and "**Economics of Justice**" (Posner, R., Harvard University Press, 1981) is the claim that **common law and even criminal law improve economic efficiency**, something that can also be said of the market mechanism. R. Posner analyses the operation of the legal system, though not from the perspective of traditional non-economic concepts such as justice, but instead from the perspective of opportunity costs or willingness to pay, and concludes that most legislative decisions are more efficient than the alternative bureaucratic methods for problem-solving, which the market cannot handle. In other words, Posner reformulated the traditional definition of justice and reduced it to the economic definition of efficiency: the criterion for the fairness and rightness of some or other action is its effect on economic efficiency, which can be measured by the growth of national income.

The economics of law does not limit itself to any individual branch of law that has something to do with open market relations; rather **it strives to spread economic concepts and methods across the entire body of legal knowledge**. It is more than likely that after the past several decades no legal principle or doctrine and no procedural or organisational aspect of the legal system remains yet to be subjected to economic analysis. Such is the opinion of one of the greatest Russian experts in neo-institutional theory – R. I. Kapelyushnikov⁶.

⁶ Вж. История экономических учений, под ред. В. Абромонова, О. Ананьина, Н. Макашевой: Учеб. пособие. – М.: ИМФРА-М, 2001, с. 676-680.

The conceptual framework of the economics of law can be presented in the following way. It is based on the assumption that agents behave like rational maximisers when applying not only market, but also nonmarket solutions (such as how to violate or not violate the law, how to instigate or not instigate a legal action, etc.)

The legal system, much like the market, **is seen as a mechanism that regulates the allocation of scarce resources**. For example, regardless of whether theft or a sale takes place, a valuable resource is moved from one agent to another. The difference is that in the market transactions are voluntary, whereas in the context of the legal system they are forced and take place without the consent of one of the parties. Many forced "transactions" occur under conditions of such high transaction costs that as a result of this voluntary transactions become impossible. A great part of torts and criminal offenses can be included in the number of forced transactions.

Despite the forced nature of the transactions, they are carried out at prices set and imposed by the legal system. Such **implicit costs** come in the form of court injunctions, payment of monetary compensation, criminal penalties, etc. This is why the apparatus of economic analysis tuned out to be applicable not only to voluntary, but also to involuntary transactions.

Such an understanding opens up completely new horizons before science. The economics of law analyse in detail **how economic agents react to different legal situations**. For example, how the speed of reaching judicial settlements affects the number of legal actions brought forward; the effect of the severity and irreversibility of the punishment on the seriousness of the crime; the effect of the characteristics of divorce law on the relative wealth of men and women; the effect of changes in traffic rules on the frequency of accidents, etc.

However, the more interesting and controversial aspect of the economics of law is related to the reverse formulation of the question: **how legal principles themselves change under the influence of economic factors**. It is assumed that the development and functioning of legal institutions is underpinned by the economic logic that ultimately their operation is guided by the principles of economic efficiency. As is known, different authors have given this principle different formulations, such as wealth maximization principle and principle of transaction cost minimization, among other things.

To illustrate what was said above, we can turn to the classic example of a farmer growing crops and a ranch owner raising domestic animals. For example, two alternative systems governing their interrelationships are known in the USA.

Under the first system, farmers are entitled to bring claims for the destruction of their crops only in those cases where they had taken the necessary measures to fence their fields to prevent the entry of someone else's animals.

Under the second system, farmers are not obliged to do so, because it is the ranch owner's duty to erect the fence, if he does not want to be fined.

The first rule is more effective when the volume of agriculture is smaller than the volume of livestock, while *the second rule* is more effective when the positions in the ratio are reversed. The first rule was adopted in U.S. states where animal husbandry was predominant and the second rule – states where agriculture dominates. This is one of the illustrations of how legal principles are established in accordance with the efficiency criterion.

A huge number of legal principles and doctrines have undergone similar tests of efficiency, with the result being positive in most cases.

According to theorists of the economics of law, this is explained by the fact that in the process of establishing precedents the courts "emulate" the market. They make the same decisions that the actual parties would resort to, having been given the opportunity to enter into negotiations on the subject of the dispute prior to that. In other words, **the legal system ensures the same allocation of rights as the market would make in the absence of transaction costs.**

The postulation that the court follows the logic of market analysis when making decisions aroused severe criticism from economists and, even more so, from jurists. In some cases, judges do in fact deliberately respect economic considerations. But the practice in most cases shows that they make decisions based primarily on the criterion of justice and not that of efficiency. However, as is claimed by the proponents of the economics of law, **the requirements for efficiency and fairness coincide more often than might be expected.** As to R. Posner's remark, we should not be surprised by the fact that in a world with limited resources, wasteful behaviour is starting to be seen by society as "unfair" and "immoral".

It should be taken into account that following the efficiency principle is attributed primarily to the system of common law, i.e. the system under which the law is created by the court itself in the form precedents (previous decisions in similar cases). It forms a kind of "**market of precedents**" that ensures their natural selection: sooner or later inefficient precedents are squeezed out by the efficient ones. This process is explained by the fact that the flow of legal actions will be intensive in those cases to which apply the inefficient precedents, whereas their replacement by efficient ones will provide an additional net increase in welfare. By being put to the test more often, the inefficient precedents would

have little chance of survival and will therefore be unable to last for a long time.

This does not at all mean that the system of common law never fails. It is important to note that the optimistic picture painted above does not extend to the rules made not by the court, but the bodies of legislature. In this case, the existence of a mechanism for selection of efficient rules is presented as extremely problematic by theorists of the economics of law.

Among many of its representatives, the efficiency principle also receives such an interpretation with respect to legal principles. To put it another way, they insist that the rules should be established taking into account the efficiency criterion. The application of this approach assumes the presence of **common requirements for the legal system.**

First, *the law must help to reduce transaction costs*, in particular to remove artificial barriers in the way of voluntary exchange and enforce the performance of contracts.

Second, *it must clearly define and reliably protect the rights of ownership* that prevent voluntary transactions from becoming forced. Under conditions of lower transaction costs, as follows from the Coase Theorem, the removal of uncertainty in the allocation of property rights will lead to an expansion in the scope of voluntary exchange.

Third, *when transaction costs are high, the legislation must choose and establish the most effective of all allocations of property rights that are available.* This is the allocation which economic agents would have used themselves, had they not been hindered by the high transaction costs.

In conclusion, we can emphasize that the legal system is called upon to facilitate the

operation of the market and, when that proves impossible, to "simulate" its results. If these prescriptions are followed, it will significantly help in the optimal use of resources in society.

The conclusions of the economics of law, relating to legal principles, have begun to penetrate the judicial and legislative practice in many countries. The famous **Coase Theorem** serves as an example of this. Reference to it is contained in 8 decisions of state courts, 17 decisions of courts of appeal and even decisions of the Supreme Court of USA.

It should be noted, however, that when it comes to determining the owner of a property and choosing the legal remedy to protect the property, **the principle of maximum economic efficiency is not at all neutral with respect to social aspects**. In particular, it leans toward preserving the *status quo* (on the basis that the existing regulations have already been through many years of natural selection and therefore have proven themselves efficient). This principle puts producers in a better position than consumers, and the rich members of society – in a better position than the poor. Along with this, **Posner's thesis of the legal system's "emulation" of the market** helps to identify and remove the rules hindering the efficient operation of the economy.

The brief retrospection of the development of the economic theory of law and its main premises points to the conclusion **that it is high time to include courses in this discipline in the Bulgarian universities**, both in faculties of economics and law. This will inevitably enrich the students' knowledge and give them a wonderful opportunity to better learn the multidisciplinary approach used on the border of two important contemporary sciences – economics and law.

Some additional information about the economists cited in the article.

Ronald Harry Coase was born in Willesden, a suburb of London, in 1910: American economist, founder of neo-institutionalism, awarded the 1991 Nobel Prize in Economics "for his discovery and clarification of the significance of transaction costs and property rights for the institutional structure and functioning of the economy".

In 1932, R. Coase graduated from the London School of Economics and in 1936 became a lecturer there. In the period of 1940-1945, he worked as a statistician in the Forestry Commission, and then moved to the Central Statistical Office of the Ministry of Defence. In 1946, he returned to work at the London School of Economics and continued the research into the organisation of the public sector, in particular post and radio broadcasting, he had begun before the war.

In 1948, as Fellow of the Rockefeller Foundation, he went to the USA for 9 months to investigate the American experience in organising radio broadcasting. In 1951, having defended his doctoral dissertation, he received an invitation from the University at Buffalo (New York State) and moved to the United States. From 1959 he worked at the University of Virginia, and became a professor at the University of Chicago and co-editor of the **Journal of Economics and Law** in 1964. He retired in 1982.

R. Coase is considered the father of neo-institutionalism, having sown the roots of a number of its aspects: the economic theory of property rights, the transaction costs theory, the economics of law and others. The most famous of his works, which brought him worldwide acclaim and a Nobel Prize in Economics, are the two articles: "**The Nature**

of the Firm" (*Coase, R. // Economica. 1937. Vol. 4, November*), which he had already written during his student years, but was published only in 1937, and "**The Problem of Social Cost**", published in 1960 and considered the most cited economics article in the post-war period.

According to Coase's own admission, the ideas he developed apply to the category of self-evident truths that modern science tends to ignore. In fact, in the basis of all his works lies the belief that any form of social organisation, be it market, company or country, requires high costs to establish and to then maintain its "operation". And from this follows that different social institutions can significantly differ in terms of the level and structure of these costs.

Guido Calabresi was born in Milan, Italy in 1932: American jurist and economist, neo-institutionalist, one of the founders of the economics of law. He was born into a family of Italian anti-fascists who emigrated to the United States in 1939. His father was a cardiologist and his mother was a scholar of European literature. Together with his wife, social anthropologist, they had three children. Calabresi graduated with honours in economics and law at Yale University, where he was later appointed professor. He was dean of Yale Law School from 1985 to 1994, and also taught at Oxford. In 1994, he was appointed district judge at the U.S. Court of Appeals by President Bill Clinton.

His innovative contributions are in the field of applying economic theory to civil law and the legal interpretation of the Coase Theorem. Under his intellectual and administrative leadership, Yale Law School became a leading research centre in the economic theory of law. Calabresi has been awarded more than 40 honorary degrees and is a member of the Royal Swedish Academy of Sciences.

In addition to the cited article from 1961, some of his more famous articles are: "**The Cost of Accidents: A Legal and Economic Analysis**" (*Yale University Press, 1970*) and "**Property Rules, Liability Rules and Inalienability: One View of the Cathedral**" (*Harvard Law Review, 1972*), co-written with Douglas Melamed.

Gary Stanley Becker was born in the City of Postville, Pennsylvania in 1930: American economist, neo-institutionalist, one of the founders of human capital theory, author of the "economic imperialism" method. Laureate of the 1992 Nobel Prize in Economics "for having extended the domain of microeconomic analysis to a wide range of human behaviour and interaction, including nonmarket behaviour".

G. Becker studied at Princeton and Chicago University where the leader of American economic science Milton Friedman and Nobel Laureate Theodore Schultz had a significant impact on his growth. In the 60's of the 20th century, Becker worked at Columbia University and collaborated with the National Bureau of Economic Research. After 1970, he returned to work at the University of Chicago. Becker's most important economic paper is the monograph published in 1964 under the title "**Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education**" (*Becker, G. S., NY Columbia Press, 1964*).

The main idea advocated in most of Becker papers is that man, in his social behaviour, especially in making vital decisions, is guided primarily by economic considerations, sometimes even subconsciously; that, on the whole, the marketplace of ideas and incentives is governed by the same laws, as the commodity market: there is supply and demand, competition, etc. This also affects issues such as marriage, starting a family, having children, education and choice of profession. According to him, many psychological phenomena, such as satisfaction

or dissatisfaction with material well-being, the manifestation of envy, altruism, selfishness, etc., can also be subjected economic evaluation and measurement.

In the book "**Essays in the Economics of Crime and Punishment**", co-written with William Landes (*Becker, G., Landes, W., 1974*), Becker examines such specific areas of law as criminal offenses, and the judicial and penal system. It promotes the idea that if people are "encouraged" to commit crimes mostly for economic reasons (if, of course, the offender is not mentally ill or insane), the crimes must be made economically disadvantageous. Obviously, this is not indisputable, since it leads to harsher punishments.

Richard Allen Posner was born in New York in 1939: American jurist and economist, neo-institutionalist, prominent representative of the economic theory of law. He is recognized as the most cited scholar of law ever, and is one of the most respected active judges in the USA. In 1959, Posner obtained a bachelor's degree in humanities at Yale University, and in 1962 obtained a bachelor's degree in law in Harvard. He worked as associate judge of the U.S. Supreme Court and at the Federal Trade Commission. He began teaching at Stanford University in 1968 and since 1969

teaches at the University of Chicago. Since 1981, he has been a professor in the Faculty of Law at the University of Chicago. President Ronald Reagan appointed him judge for the Seventh Circuit in 1981, and later Posner became Chief Judge of that court for the period of 1993-2000. He is a member of the American Bar Association and the American Law Institute. From 1972 to 1981, Posner, one of its founders, edited the Journal of Legal Studies. He was elected judge in the U.S. Court of Appeals.

R. Posner is a prolific author who has written over 40 books and hundreds of articles on jurisprudence, philosophy and history of law, federal law, moral theory, intellectual property, antitrust law and public intellectuals. He is described as a pragmatist in philosophy, a classical liberal in politics and an economist in legal methodology. Posner is also well known as a publicist, covering a wide range of public events in the U.S. and worldwide. His greatest contribution is the systematic study of the interaction between law and economics. The New York Times defines him as one of the most important scientists in the field of antitrust law in the second half of the twentieth century. In December 2004, he created a blog with Gary Becker, Nobel Laureate in Economics, where many interesting issues are discussed. EA