Law and the Imperialism of Economics: An Introduction to the Economic Analysis of Law and a Review of the Major Books

Robert D. Cooter

Follow this and additional works at: https://scholarship.law.berkeley.edu/facpubs

Part of the Economics Commons, and the Jurisprudence Commons

Recommended Citation

This Article is brought to you for free and open access by Berkeley Law Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Berkeley Law Scholarship Repository. For more information, please contact jcera@law.berkeley.edu.
LAW AND THE IMPERIALISM OF ECONOMICS: AN INTRODUCTION TO THE ECONOMIC ANALYSIS OF LAW AND A REVIEW OF THE MAJOR BOOKS

Robert D. Cooter*

Since the 17th century, social scientists have tried to accomplish in the study of society what Newton achieved in the study of nature. Everyone who buys groceries or seeks work knows that the power of economics is feeble compared to physics, but economists at least have managed to make Newton's mathematics the structure of their discipline. In the process of absorbing Newton's mathematics, which began in the 1880s and was completed by the time Samuelson published the Foundations of Economics in 1942,1 economics gained technical superiority over other social sciences. The technical superiority of economics makes its spread into other social sciences irresistible, just as Newtonian mechanics spread into economics. In political science, history, demography, and sociology there is an approach which uses the quantitative methods and behavioral theories of microeconomics. The law of entropy appears to work backwards for ideas: Rigor drives out less structured modes of thought.

This aggression against softer subjects has been called "economics imperialism." One victim, or beneficiary, is the law. Left to its own devices, the law stood no more chance of developing quantitative methodology than Australia stood of developing the rabbit. The traditions of legal scholarship point in a different direction. Most lawyers conceive of empirical research as analyzing appellate cases, and mainstream legal theory continues to be the philosophy of law, whose technical foundation is the analysis of language. The lawyer pouring over cases contrasts vividly with


1. P. SAMUELSON, FOUNDATIONS OF ECONOMICS (1942).
the economist manipulating equations and splicing computer tapes.

The contrast was not so vivid fifty years ago when mathematical economics was still a narrow specialty. At that time, empirical economics consisted partly of case studies, e.g., a case study of the shoe industry or a case study of an industrial union, whose style is similar to descriptions of the factual background in legal disputes. Theoretical economics could still be conducted in ordinary, as opposed to mathematical, language.

It turned out that the subject was advanced more by analyzing statistics than by scrutinizing cases, more by taking derivatives than by parsing phrases. Many economists today confidently expect the history of economics to be repeated in law. In fact, economic models have found their way into law journals, and analyses ultimately derived from these models are presented in the first year law school curriculum. There is a competition between alternative styles of research whose potential effects upon legal education and scholarship are profound.

Watching law respond to economic analysis is rather like watching an ecological system rearrange itself after release of an exotic animal. Like the rabbits in Australia, economists have discovered an unoccupied niche in the ecology, namely the absence of quantitative reasoning in law, and are moving quickly to fill it. The aliens are expansive, brash, unconventional. Traditional lawyers are contemptuous of the aliens but unsettled by their presence. Each side would like to overcome the other by posturing in methodological disputes. Economics flaunts its ties with natural science, the last surviving authority since God's recent death. The economists claim that their approach is scientific, rational, consistent, unenslaved by tradition. Lawyers are fond of trying to refute the economic approach without going through the intermediate step of understanding it, e.g., "It's just utilitarianism all over again." The detractors claim that the economic approach is too abstract, untested, and irrelevant to the courtroom.

The strengths and weaknesses of the economic analysis of law are better revealed by examining its central concepts than by engaging in methodological disputes. There are two fundamental concepts in economics, which were borrowed from Newton's calculus, first applied to markets, and which are now being applied to social phenomena as different as warfare and marriage. The first concept is maximization. Consumers are said to maximize utility, firms to maximize profits, politicians to maximize votes, bureaucracies to maximize revenues, charities to maximize social welfare, etc. The second concept is equilibrium, which is a stable pattern of interaction achieved when everyone is maximiz-
ing simultaneously. Equilibria have been studied for markets, elections, club memberships, competitive games, team effort, budgetary allocations, etc. No habit of thought is so deeply ingrained in economists as the urge to characterize each social phenomenon as an equilibrium in the interaction of maximizing individuals or institutions.

Lawyers who are critical of economics heap scorn upon the belief that maximization and equilibrium are fundamental categories of social explanation. Why stress equilibria instead of change? Isn't it better for the analysis to be dynamic instead of static? Why stress maximization instead of psychological or sociological theories? Isn't it better to base predictions about law upon the psychology of choice rather than the logic of choice, to acknowledge irrationality rather than postulate rationality, to recognize social norms rather than assume selfishness?

Suppose that a beginning student in geometry challenged his teacher: Why assume that the shortest distance between two points is a straight line? How can a point take up no space? There is substance to these criticisms, as mathematicians know, but a novice is unlikely to guess what is at stake. Similarly, the lawyers who criticize economics from the outside seldom say anything of merit about its fundamental concepts. They attack its technical language without understanding the techniques for which the language was created.

Maximization is merely a simple way to quantify social behavior. Suppose that an individual or institution can rank alternative states of the world from bad to good. Real numbers can be ranked from small to large. Thus, the ranking of alternatives can be associated with real numbers. In this way the values of the individual or institution can be quantified. The economic theory of choice is the theory of value based upon the real number system.

Once value is quantified, or states are ranked, then it is natural to choose the maximum—the state with the highest rank. Economists assume that individuals and some institutions act as if they rank states and choose the best available alternative, and it does not matter in principle what they maximize, e.g., money, votes, or welfare. All that is required is the minimum level of purposefulness necessary for quantification. Purposefulness may be the product of deliberation, as when a firm computes profits, or a rote response, as when a laboratory rat presses a bar to obtain food.

From an analytic standpoint, the simplest pattern of interaction among maximizing individuals is one that does not change. It is much simpler to analyze a change by comparing the initial
and final equilibria than by attempting to trace out the entire path of development. Contemporary economics includes theories of growth, cycles, and disequilibria, but the comparison of equilibria remains the basic approach.

The concept of efficiency is less fundamental in the mathematical sense, but just as prominent in economics as maximization or equilibrium. A process is efficient when it yields the maximum output from given input, or equivalently, when it yields a given output with the minimum input. Economists draw on many different forms of this concept, such as efficient production, efficient exchange, Pareto efficiency, national income maximization, wealth maximization, and utilitarian efficiency. Most economists move easily from one form to another, but the subtle shifts in significance are lost upon noneconomists.

The application of fundamental economic concepts to the law can be illustrated by three examples. First, consider a contract to deliver oil from the Middle East to a European manufacturer. War breaks out in the exporting country, so the oil company cannot perform as promised. The lack of oil causes the European manufacturer to suffer losses. The contract is silent about the risk of nonperformance in the event of war.

The courts might excuse performance as "impossible," or they might find a breach of the contract requiring the oil company to compensate the manufacturer for its losses. Which result will promote economic efficiency? The standard answer is that liability should be assigned to the party who is in the best position to insure against the misfortune which caused nonperformance. An important aspect of insurance is assessing the risk. A company doing business in the Middle East is in a better position to assess the risk of war in that region than a European manufacturer, so economic efficiency apparently would require holding the oil company liable.

This example is consistent with the outcome of some decided cases, but the reasons given by the courts, taken at face value, are different from the reasons given in the economic analysis. The economic analysis concerns the efficient assignment of legal rights and duties, but efficiency is not stressed overtly by judges.

Our second example of the economic approach is a classic parable. Suppose that a factory emits smoke which dirties the clothes cleaned by a commercial laundry. There are two legal regimes to consider. Under the first regime the courts are prepared to give an injunction against the factory to stop polluting (pollutee's rights). Alternatively, the courts might give the laundry no legal remedy (polluter's rights).

What difference will the rule of law make to the amount of
pollution? The standard answer from economic analysis is “none.” The pollution level will be unaffected because the laun-
dry and the factory will conclude a private agreement concerning pollution. The privately-agreed-upon pollution level will be the
same under either rule of law.

To see why, suppose the owner of the laundry marries the
owner of the factory. We would expect the couple to set pollution
at the level which maximizes the total profits of the two enter-
prises in order to maximize their combined income. Rational barg-
gainers will do just as well as the married couple. If the two firms
are owned by unrelated individuals, but the individuals bargain
until an agreement exhausts the possibilities for mutual gain, then
the total profits of the two enterprises will also be maximized.
For example, if the pollution damage suffered by the laundry is
$5,000, and the cost to the factory of eliminating pollution is
$10,000, then the laundry is unlikely to enjoin the polluter. In-
stead of forcing the polluter to abate, it would be preferable to
both parties for the polluter to pay the laundry for continuing to
pollute, say $7,500. This is the kind of deal that would probably
emerge from private negotiations.

There is a useful way to describe this agreement. If someone
values an asset more than its owner, then there is scope for mutual
gain by exchange. This is true for automobiles, wheat, labor, and
pollution rights. We may think of the agreement between the
laundry and the factory as an exchange of pollution rights. The
background assumption is that bargaining does not cease until the
potential gains from exchange are exhausted. It is easy to see that
the potential gains are not exhausted unless the total profits from
the two enterprises are maximized.

As a third example of the economic approach, consider the
use of fines to deter crimes. Some crimes are economic in the
sense that they are committed after rational computation of the
risk and the potential gain. Any desired level of deterrence for
such crimes can be achieved by setting the risk at the appropriate
level. The risk depends upon the probability and magnitude of
the punishment. Suppose that the punishment in question is a
fine. If apprehending offenders is costly and administering fines is
cheap, then the cheapest way to achieve any desired level of deter-
rence is to invest little in apprehending offenders and to fine se-
verely those who are apprehended. Moreover, it can be shown
that it is never efficient from a social viewpoint to incarcerate an
offender unless his ability to pay fines has been completely
exhausted.

Economists say that the conclusions in these examples can be
proved. The proof is a deduction by mathematics from standard
economic assumptions, not a test against the facts. The first step in a proof is to assume that the individuals or institutions who make decisions are maximizing specified objectives, e.g., businesses are maximizing profits, and consumers are maximizing utility. The second step is to show that the interaction among decisionmakers settles down into a stable equilibrium. The third step is to judge the equilibrium on a criterion of efficiency. Thus, it is possible to "prove" that liability for breach of contract is efficient in our first example, that polluters' rights and pollutees' rights result in the same amount of pollution, and that the criminal offender's ability to pay fines should be exhausted before resorting to incarceration.

Scientific method requires an additional step, namely, testing predictions against the facts. For example, it is desirable to test the prediction that the assignment of liability in nuisance disputes does not influence the allocation of resources. A convincing test would have to involve statistics and, possibly, econometrics. The economic analysis of law has generated far more proofs than tests because the data available for tests is of poor quality.

Economic modeling of the law can be contrasted with traditional legal scholarship on several levels. An obvious contrast is between taking derivatives and parsing phrases. Few people ever become facile at both techniques, so there is a persistent, irritating problem of translation. A second level of contrast is between inductive and deductive reasoning. The traditional case method proceeds inductively by examining the rhetoric of judges in order to extract rules from particular decisions. Ideally, the economic approach proceeds by constructing a mathematical model, deducing testable hypotheses from it, and conducting the tests. Thus the economic approach carries prefabricated hypotheses to the data, whereas the traditional method builds directly from the cases.

Setting methodology aside, what are the novel substantive claims of the economic analysis of law? The fundamental claim is that maximization, equilibrium, and efficiency are key concepts for analyzing the law. Several versions of this claim can be distinguished according to whether the concepts are used to reduce, explain, explicate, or predict consequences of laws. The strongest claim is that the law can be reduced to economics by substituting economic concepts for such traditional legal concepts as justice, right, duty, negligence, etc. The claim to reduce law to economics is similar to the claim in psychology that mind can be reduced to behavior. Weaker than reductionism is the claim that economics can explain the law. Rather than eliminating legal concepts, economics is supposed to explain their coherence and to derive rules of law from them. Weaker still is the claim that economics can
clarify the logical structure of law, but not capture all of the underlying reality. In other words, economics explicates the law, but falls short of a complete explanation. Finally, the weakest claim is that economics cannot explain or explicate the law, but that it can predict the consequences of some legal rules. This claim places economic reasoning outside the law, just as consequences are outside the action which causes them.

The claim that law can be reduced to economics is too preposterous for anyone but an academic to contemplate. There may be some areas of law which can be explained by economics, but there are other areas of law in which economic explanations will always be incomplete. However, there is no doubt that economics has explicated the law more successfully than legal scholars thought likely twenty years ago when the enterprise began. There is apparently wide scope for using the fundamental concepts of economics to explicate the law.

There are, however, certain weaknesses in the economic approach which limit its value. One of the dangers is not unique to economics, but is shared by all theories of law which attempt to deduce judicial outcomes from general propositions not stated in the courts' opinions. If judicial decisions can be explained without reproducing the opinions, then the reasons given in the opinions are not the real reasons for the decisions. If the real reasons are latent and not manifest in the opinions, then the opinions are diminished in dignity and stature. All such theories of law impugn the dignity of judges in the same way that the Freudian distinction between manifest and latent content of thoughts impugns consciousness. To be taken seriously by courts, a theory of law must take the opinions of judges seriously. In so far as judges are regarded as moved by principles which they do not utter, and unmoved by principles which they do utter, the theory will be worthless in arguing a case.

A second limitation is the suspicion bordering on hostility with which economists regard jurisprudence. Economists tend to regard it as insubstantial theories of justice worked out over a couple thousand years of argument. Like prophets in the desert, this conceit insulates economists from the mainstream of legal theory so that doctrine can be refined without impurities. Insensitivity and crudeness of language, which plagues the economic analysis of law, is partly due to the hostility of economics to jurisprudence. Many disputes in law become trivial when stripped of their jurisprudential implications. The economic analysis needs contact with jurisprudence for the sake of depth and subtlety.

I have sketched the contrast in broad strokes. The reader who wants a detailed understanding of this intriguing confronta-
tion must go to academic journals, but perusing the major books is sufficient to acquire a sense of the issues. The first obstacle to the development of the economic analysis is translating legal language into economic language. This step identifies the mathematical structure of the phenomenon under consideration. By adopting the language of economics, we gain access to an elaborate, deductive system of thought. The books under review are largely concerned with the problem of translation.

The indisputable leader in translation is Richard Posner. He works very fast, and it is characteristic of him to publish the second edition of his text before a rival appears. About one-third of *Economic Analysis of Law* is devoted to traditional topics such as antitrust, business regulation, financial markets, taxation, and the transmission of wealth. Lawyers always knew that these topics have a lot to do with economics. It is not so obvious that economics applies to the topics in the remaining two-thirds of the book, namely common law, the legal process, and constitutional law. The new economic analysis of law as exemplified by Posner's work differs from its predecessors by reaching out to cover topics whose economic character is not obvious and by drawing upon economic theory rather than economic wisdom.

It may be useful to give a mundane example of Posner's efforts at translation. He describes court precedents as a stock of capital. This is not a mere metaphor. Economists have developed capital theory rigorously, and this translation suggests the application of that theory to the legal process. In fact, economists have analyzed legal precedents using models similar to those used to describe supply and demand.

Adopting a technical language has the disadvantage of obscuring common sense. Technical discourse advances logical purity rather than balance, consistency rather than sensitivity. Posner has not escaped this difficulty. Indeed, he is regarded in some circles as an intellectual provocateur. Certainly his style is to press forward with economic concepts even at the risk of sounding outrageous.

Posner has a definite conception of law and economics, which he develops throughout the text. This conception stresses that economic efficiency, as opposed to traditional conceptions of justice or utility, is the underlying concern of law. The stress upon efficiency, rather than, say, distribution, gives a conservative cast to some of his arguments, although mostly his arguments are technical rather than political.

Werner Hirsch's text, *Law and Economics: An Introductory*
Analysis, is about half the bulk of Posner's and does not aim at comprehensiveness. Hirsch covers the common law topics in four chapters, devotes a chapter to criminal law, and then deals with some selected topics such as zoning and antitrust. Like Posner, Hirsch is concerned with translating legal concepts into economic structure. Hirsch is less concerned than Posner with communicating a conception of the subject, so his treatment is less provocative. In the areas of overlap, there is substantial similarity between the books.

J.M. Oliver's thin volume, entitled Law and Economics: An Introduction, is more accurately described as six essays, rather than a textbook. Arguments are hedged and claims are muted in the classical English style. While Posner and Hirsch use graphs and algebra sparingly, Oliver entirely dispenses with them. Oliver demands less of his readers than Posner and gives them less.

A new book will appear shortly which is similar to Oliver's in length and remarkable for its clarity. I have read only a "tentative final draft" of A. Mitchell Polinsky's An Introduction to Law and Economics, so I must restrict myself to a few remarks in praise of it. Instead of trying to survey a body of law, this book is organized around a series of examples which convey a feeling for the technique and style of the economic analysis of law. The examples are drawn from the common law areas at the heart of the traditional law school curriculum. This book conveys an appreciation for the economic analysis of law without demanding a large investment of time from the reader.

An alternative to reading one of these introductions is to peruse the articles reprinted in an edited volume. Economic theories explaining the common law's development have been particularly concerned with the problem of property rights. Three edited volumes are organized around this problem: Bruce Ackerman's Economic Foundations of Property Law, Henry Manne's The Economics of Legal Relationships, and Furubotn and Pejovich's The Economics of Property Rights. Any of these volumes will do, but Ackerman's volume has the advantage of being published in an inexpensive paperback.

Yet another alternative is to read one of the books that deals intensively with a narrow set of issues. A pioneering work in the

---

8. The Economics of Property Rights (E. Furubotn & S. Pejovich eds. 1974).
economic analysis of common law is Guido Calabresi's *The Costs of Accidents: A Legal and Economic Analysis.* Although somewhat dated, this book is still worth reading—especially for lawyers. A different kind of book, which is also specialized, is R.W. Anderson's *The Economics of Crime.* This volume is too technical for a general audience, but mathematically inclined readers will enjoy it.

Criminal law is unusual in being an area where government data is available for econometric research, although the quality of data often is poor. *Crime and Public Policy: An Economic Approach,* by William Luksetich and Michael White, offers a chance to assess the strengths and weaknesses of econometrics. The chapters on the deterrent hypothesis, especially the deterrent effects of capital punishment, show the technical superiority of economics and the difficulties encountered when working with low quality data. Luksetich and White offer a less technical presentation than does Anderson of supply and demand theory as applied to crime.

What does the economic analysis of law amount to? Is it the beginning of a true science of law, or is it a fad? Law will not be reduced to a science, but there is scope for building a science within law based upon fundamental concepts of economic explanation, namely maximization, equilibrium, and efficiency. The purpose of this science is to explicate the law. The accomplishments as exhibited in these books are shabby by comparison to the dream, but such discrepancies motivate the best efforts of intellectuals. If rigor drives out less structured modes of thought, as appears to be the case from recent intellectual history, then the expansion of deeper economic analysis into the law is inevitable.

---