

# FOUNDATIONS OF THE ECONOMIC APPROACH TO LAW



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# FOUNDATIONS OF THE ECONOMIC APPROACH TO LAW

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## PREFACE

In putting together this reader, I have followed a somewhat different approach than most previous editors in the field, in that I have not seen my primary task as trying to survey economic analyses of the major fields of law. Instead, this book is organized around basic methodological concepts. It focuses on what is distinctive about economics as a way of thinking and on how economic analysis compares and contrasts with more traditional methods of legal reasoning. In my view, most lawyers exposed to law and economics do not acquire a solid grounding in these basics. Most major casebooks and textbooks in the field are concerned primarily with applications and deal with economic methodology only briefly or tangentially. As a result, both students and nonspecialists often lack a clear idea of what normative, descriptive, and interpretative positions the use of economics really commits them to; and while they may learn to use economics adequately or even expertly, they are less well equipped either to critique or to defend its use.

For this reason, as its title suggests, this book stresses the foundations. It begins with an introductory chapter on the building blocks of economic analysis: the model of rational choice, which provides economics with its descriptive theory of human behavior; the concept of efficiency, which provides its primary normative criterion; and the idea of positivist social science, which provides the underlying pragmatic justification for distinguishing between fact and value and for constructing simplified models of the world. The succeeding chapter introduces and compares the two main “schools” of law and economics—often caricatured as “Chicago” and “non-Chicago”—which I present as alternative economic models of legal relations, based on differing assumptions about the relative institutional efficacy of private exchange and governmental regulation.

With these fundamentals established, I turn to applications. The applications are organized not by field of law, however, but by analytical concepts of economics that cut across traditional doctrinal divisions. Still, those interested in doctrinal topics will find much here to read and discuss. The chapter entitled “A Survey of Basic Applications,” for instance, focuses on standard problems of incentives—externalities, deterrence, collective action, and the like—in the context of the traditional first-year curriculum: tort, contract, property, criminal law, and procedure. The motive behind this chapter is that students are likely to be familiar with these problems from previous courses and that such a presentation will help them see the functional connections among incentive problems across different fields of law.

The next four chapters refine this basic approach by introducing a series of more advanced concepts that are central to understanding many legal institutions. Chapter 4 discusses the problem of strategic behavior; chapter 5 introduces the economics of risk, uncertainty, and insurance; chapter 6, the issue of incomplete or imperfect information; and chapter 7, the difficulties stemming from imperfectly rational behavior. The point of this organization is to demonstrate to a legal audience how studying economics can help them progress from simpler and more tractable representations of the world to more complex and realistic ones. The purpose is partly pedagogical (since the simpler models are a prerequisite to understanding more complex ones), but I also mean to help lawyers appreciate the methodology of using social science models generally—and to help them see that important lessons can be learned at all levels of complexity. As before, the presentation cuts across different fields of law to highlight the connections among functionally similar economic problems. In these later chapters I also draw examples

from upper-level courses of study such as environmental law, bankruptcy, and products liability.

Chapter 8 surveys a variety of critiques of the economic approach. I have tried in this chapter to classify the critiques according to the perspectives they reflect, but I should make clear what I have in mind by this classification, since the perspectives overlap to some extent. By the liberal critique, I mean the objection that economics, by viewing the social interest as an aggregate, fails to do justice to individual persons or to respect their rights. What I call the paternalist critique calls into question the assumption that individuals are the best judges of their own interests; and the sociological critique questions whether individuals are motivated primarily by self-interest, narrowly defined, or by social relations more generally. The radical critique argues that law and economics is a deceptive apology for the status quo, in that it purports to offer a neutral mediating institution to resolve conflict among competing social interests where no such institution is possible. The communitarian critique argues that economics, by taking individual wants and preferences as givens, ignores the extent to which they are socially determined, and so disparages the possibility that legal institutions can help to work toward a better society. Finally, the Legal Realist critique argues that social reality is too complex to be adequately captured by formalistic approaches such as economics and that attempting to force legal analysis into any single framework will distort and impair its conclusions.

The final chapter presents three readings on the application of economics to family law, including Landes and Posner's controversial article analyzing adoption as a market for children. The critiques presented in chapter 8 can seem abstract, especially for those not well versed in social theory, and the adoption issue—along with the larger questions addressed by the economics of the family—raises them in a vivid and concrete fashion. Because the earlier chapters are organized around economic concepts, furthermore, this is the reader's first opportunity to look at a legal field on its own terms. It provides a good opportunity for the reader to synthesize the economic concepts that have been learned in previous chapters and exposes students to at least some applications that are on the frontier of the discipline. After all, it was not so long ago that law and economics itself was on the frontier.

### ***A Note for Teachers***

This reader is designed to serve as a primary text for a one-semester law school course in the economic analysis of law, and I have used it for that purpose myself. Alternatively, it could serve as a supplement to a casebook or textbook in such a course. Because of its focus on jurisprudential issues, it is less well suited for an audience of economics undergraduates, though economics graduate students curious about the methodological foundations of their discipline will find much here of interest. There is a lot of material here, however, so individual teachers using it may wish to pick and choose according to their interests; those using this book as a course supplement will need to be especially selective. Accordingly, each of the chapters is relatively self-contained and can be omitted without loss of continuity, with the exception of chapters 2 and 3. Additionally, some of the notes and questions to chapter 9 presuppose familiarity with the material covered in chapter 8.

I recognize that many teachers of law and economics are accustomed to organizing their courses around substantive law topics such as tort, contract, and property and that the structure of this book may make it more complicated to present sustained analyses of individual fields. Chapter 9 on family law is intended in part to address this concern. In my view, however, the traditional doctrinal organization obscures the economic approach's main contribution, which is to offer a new set of categories that cut across traditionally defined fields, allowing lawyers to recognize—and use—functional analogies and distinctions they had not previously appreciated. When an externality argument is used to analyze one legal doctrine, a risk-allocation argument another, a Coasian argument still another, and it is never made explicit why one argument is used here and another there, this larger lesson is lost. Students taught in this manner too often come to regard economics as an ad hoc tool, useful for reaching whatever results might seem appropriate on ulterior grounds, rather than as a systematic approach for explaining human behavior and clarifying normative choices. I hope, therefore, that even teachers who continue to organize their course along doctrinal lines will find some benefits in this reader's conceptual presentation.

Some teachers may prefer to defer the material in chapter 1, which deals with the underpinnings of the economic approach, until later in the course. There is room for a difference of opinion here. In my view, it is both better pedagogy and more intellectually honest to present economics' main positive and normative assumptions up front. I have found that when teaching good students who have no prior background in the subject, a policy of full disclosure helps to avoid the repeated detours and tangents that inevitably arise as the students discover and raise such questions on their own. Some students, however, may find this relatively theoretical material more accessible after having studied a number of more concrete applications in the fields of contract, tort, and property. Teachers who follow the latter approach may wish to place chapter 1's material either before or after chapter 7.

Additionally, when teaching the material in this reader, I have found it useful to provide students with some major legal cases that illustrate or provide opportunities to apply the ideas put forth by the individual readings. Different teachers may wish to use different cases as illustrations, depending on their backgrounds and interests, but I have found the following to offer good springboards for discussion:

Chapter 2: *Sturges v. Bridgman*, 11 Ch. 852 (1879); *Orchard View Farms v. Martin Marietta Aluminum*, 500 F. Supp. 984 (D. Or. 1980).

Chapter 3: *Boomer v. Atlantic Cement Co.*, 26 N.Y.2d 219, 309 N.Y.S.2d 312, 257 N.E.2d 870 (1970); *Spur Industries v. Del E. Webb Development Co.*, 494 P.2d 700 (Ariz., 1972); *U.S. v. Carroll Towing Co.*, 159 F.2d 169 (2d Cir. 1947); *The T. J. Hooper*, 60 F.2d 737 (2d Cir. 1932); *Peevyhouse v. Garland Coal Co.*, 382 P.2d 109 (Okla., 1962).

Chapter 4: *Austin Instrument v. Loral Corp.*, 29 N.Y.2d 124, 272 N.E.2d 533 (1971); *Batsakis v. Demotsis*, 226 S.W.2d 673 (Tex. Ct. Civ. App., 1949); *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir., 1965).

Chapter 5: *Taylor v. Caldwell*, 3 Best & S. 826 (Q.B., 1863); *Escola v. Coca-Cola Bottling Co.* 24 Cal. 2d 453, 150 P.2d 436 (1944); *Alcoa v. Essex*, 499 F. Supp. 53 (W.D. Pa. 1980).

Chapter 6: *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817); *Hadley v. Baxendale*, 9 Exch. 341 (1854); *EVRA Corp. v. Swiss Bank Corp.*, 673 F.2d 951 (7th Cir. 1982).

Chapter 7: *Henningsen v. Bloomfield Motors*, 32 N.J. 358, 161 A.2d 69 (1960); *Helling v. Carey*, 519 P.2d 981 (Wash. 1974).

Chapter 9: *In the Matter of Baby M*, 109 N.J. 396, 537 A.2d 1227 (N.J., 1988).

### ***Bibliographical Note***

The citations in the notes at the end of each chapter are intended to be representative rather than exhaustive. Readers wishing a more systematic bibliography may wish to consult Boudewijn Bouckaert and Gerrit De Geest, *Bibliography of Law and Economics* (Dordrecht: Kluwer Academic Publishers, 1992). Two separate multivolume encyclopedias of law and economics, both comprising individual articles contributed by leading researchers in the field, have recently been completed: the *Encyclopedia of Law and Economics*, edited by Professors Bouckaert and De Geest and forthcoming from Edward Elgar Press (and now available on the Internet at <http://encyclo.findlaw.com>), and the *New Palgrave Dictionary of Economics and the Law* (London: Macmillan Press, 1998), edited by Peter Newman. Those seeking a one-volume survey of legal applications of economics can do no better than to consult Richard Posner's classic text *Economic Analysis of Law* (New York: Aspen Law and Business, 5th ed. 1998). Robert Cooter and Thomas Ulen's *Law and Economics* (Reading, MA: Addison-Wesley, 3d ed. 1999) offers a survey of technical models suitable for advanced undergraduates in economics, and A. Mitchell Polinsky's *An Introduction to Law and Economics* (New York: Aspen Law and Business, 2d. ed. 1989) provides a brief and exceptionally clear introduction to the issues raised in this reader. Readers in search of a basic introduction to the tools and principles of microeconomics should consult either Steven Crafton and Margaret Brinig, *Quantitative Methods for Lawyers* (Durham, N.C.: Carolina Academic Press, 1994), or for a more comprehensive treatment, Robert Pindyck and Daniel Rubinfeld, *Microeconomics* (Englewood Cliffs, N.J.: Prentice Hall, 1995).

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