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ECONOMIC ANALYSIS OF LAW

EIGHTH EDITION

RICHARD A. POSNER

*Judge, U.S. Court of Appeals for the Seventh Circuit
Senior Lecturer, University of Chicago Law School*



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CHAPTER 2

THE ECONOMIC APPROACH TO LAW

§2.1 Its History

Until the 1960s, economic analysis of law was virtually synonymous with antitrust economics, although there had been some economic work on tax law (Henry Simons), corporate law (Henry Manne), patent law (Arnold Plant), contract law (Robert Hale), and public utility and common carrier regulation (Ronald Coase and others). The records in antitrust cases provided a rich mine of information about business practices; and economists, who at the time were preoccupied with the question of monopoly, set about to discover the economic rationales and consequences of such practices. Their discoveries had implications for legal policy, of course, but basically what they were doing was no different from what economists traditionally had done—trying to explain the behavior of participants in explicit economic markets.

The economic analysis of antitrust, and of other legal regulation of explicit economic markets, remains a prosperous field and receives attention in this book. However, the hallmark of the “new” law and economics—the law and economics that has emerged since about 1960—is the application of economics to the legal system across the board: to common law fields such as torts, contracts, restitution, and property; to statutory fields such as environmental regulation, intellectual property, corporate and financial law, and pension law; to the theory and practice of punishment; to civil, criminal, and administrative procedure; to evidence; to the theory of legislation and regulation; to law enforcement and judicial behavior and administration; and even to constitutional law, international and development law, primitive law, admiralty law, family law, and jurisprudence.

The new law and economics began with Guido Calabresi’s first article on torts and Ronald Coase’s article on social cost.¹ These were the first modern²

§2.1 1. Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 *Yale L.J.* 499 (1961); Ronald H. Coase, *The Problem of Social Cost*, 3 *J. Law & Econ.* 1 (1960).

2. Important work on the economics of criminal law was done in the eighteenth and early nineteenth centuries by Beccaria and Bentham—and remains well worth reading. Cesare

attempts to apply economic analysis systematically to areas of law that do not regulate avowedly economic relationships. One can find earlier glimmerings of an economic approach to the problems of accident and nuisance law that Calabresi and Coase discussed,³ especially in the work of Pigou,⁴ which provided a foil for Coase; but the earlier work had made little impact on legal thought. Traditionally, economics had been thought to be defined by its subject rather than by its method. Its subject was the economy; and the legal system, though understood to affect the economy, was not thought to be itself an economic system, in the sense of a site of activity that could profitably be studied in economic terms. (Climate affects the economy, but the climate is not an economic system.) As a result, with the startling exception of Bentham's utilitarian analysis of criminal punishment, there was little economic writing on law outside those areas, mainly antitrust, where the law seemed to have explicitly incorporated economic concepts, such as, in the case of antitrust, monopoly and competition. A deeper, wider, more sustained engagement of economics with law had to await recognition (which again had been anticipated by Bentham) that economics is a theory as well as an "area study" — specifically the theory of rational choice, a theory that can in principle be applied to any social activity (even nonhuman), thus including law, even when law regulates nonmarket activities, such as crime, adjudication, or marriage.

Coase's article introduced the Coase Theorem, which we met in Chapter 1, and, more broadly, established a framework for analyzing the assignment of property rights and liability in economic terms. This opened a vast field of legal doctrine to fruitful economic analysis.⁵ An important, although for a time neglected, feature of Coase's article was its implications for the positive economic analysis of legal doctrine. Coase intimated that the English law of nuisance had an implicit economic logic. Later writers have generalized this insight and argued that many of the doctrines and institutions of the legal system are best understood and explained as efforts to promote the efficient allocation of resources — a major theme of this book.

Beccaria, *On Crimes and Punishments* (Henry Paolucci trans., 1963); Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation*, in 1 *Works of Jeremy Bentham* 1, 81-154 (John Bowring ed., 1843); Bentham, *Principles of Penal Law*, in 1 *id.* at 365. See Richard A. Posner, *The Law and Economics Movement from Bentham to Becker*, in Posner, *Frontiers of Legal Theory*, ch. 1 (2003). Other precursors are discussed in Ian Ayres, *Discrediting the Free Market*, 66 *U. Chi. L. Rev.* 273 (1999); Charles K. Rowley, *Law and Economics From the Perspective of Economics*, in *The New Palgrave Dictionary of Economics and the Law*, vol. 2, pp. 474, 474-476 (Peter Newman ed., 1998); Barbara Fried, *The Progressive Assault on Laissez Faire: Robert Hale and the First Law and Economics Movement* (1998); Neil Duxbury, *Robert Hale and the Economy of Legal Force*, 53 *Modern L. Rev.* 421 (1990); Herbert Hovenkamp, *The First Great Law & Economics Movement*, 42 *Stan. L. Rev.* 993 (1990).

3. See William M. Landes & Richard A. Posner, *The Economic Structure of Tort Law*, ch. 1 (1987), for examples.

4. A.C. Pigou, *The Economics of Welfare*, ch. 9 (4th ed. 1932).

5. The modern literature on property rights also reflects, however, the influence of Frank Knight's important early article, *Some Fallacies in the Interpretation of Social Cost*, 38 *Q.J. Econ.* 582 (1924); see §3.1 *infra*.

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A list of the founders of the “new” law and economics would be seriously incomplete without the name of Gary Becker. Becker’s insistence on the relevance of economics to a surprising range of nonmarket behavior (including charity, love, and addiction), as well as his specific contributions to the economic analysis of crime, racial discrimination, and marriage and divorce, opened to economic analysis large areas of the legal system not reached by Calabresi’s and Coase’s studies of property rights and liability rules.⁶ Becker is the modern Bentham.

§2.2 Positive and Normative Economic Analysis of Law

Subsequent chapters will show how the insights of the pioneers have been generalized, empirically tested, and integrated with the insights of the “old” law and economics to create a comprehensive economic theory of law having explanatory power and empirical support. The theory has normative as well as positive aspects. Although the economist cannot tell society whether it should seek to limit theft, he can show that it would be inefficient (see §1.2 *supra*) to allow unlimited theft and can thus clarify a value conflict by showing how much of one value—efficiency—must be sacrificed to achieve another. Or, taking a goal of limiting theft as given, the economist may be able to show that the means by which society has sought to attain that goal are inefficient—that society could obtain more prevention, at lower cost, by using different methods. If the more efficient methods impaired no other values, they would be socially desirable even if efficiency were low on the totem pole of social values.

As for the positive role of economic analysis of law—the attempt to explain legal rules and outcomes as they are rather than to change them to make them better—we shall see in subsequent chapters that many areas of law bear the stamp of economic reasoning. Few judicial opinions contain explicit references to economic concepts. But often the true grounds of legal decision are concealed rather than illuminated by the characteristic rhetoric of opinions. Indeed, a good legal education equips students to dig beneath

6. For the character of Becker’s contributions to economics, see Gary S. Becker, *The Economic Approach to Human Behavior* (1976); Becker, *A Treatise on the Family* (enlarged ed. 1991); Becker, *Accounting for Tastes* (1996). Of particular importance to law and economics was Becker’s article *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968). The new law and economics is now the subject of an extensive literature; besides the pertinent portions of this book, book-length treatments include Robert Cooter & Thomas Ulen, *Law and Economics* (4th ed. 2003); Landes & Posner, *supra* note 3; A. Mitchell Polinsky, *An Introduction to Law and Economics* (3d ed. 2003); Richard A. Posner, *The Economics of Justice* (1981); and most recently, Steven Shavell, *Foundations of the Economic Analysis of Law* (2004).

the rhetorical surface to find those grounds, many of which may turn out to have an economic character. That is no surprise. The United States has always been a commercial society. Many legal doctrines date back to the nineteenth century, when a laissez-faire ideology based on classical economics was the dominant ideology of the educated classes. And with the fall of communism, there has been a strong resurgence of free-market ideology both in the United States and throughout much of the rest of the world (the resurgence began earlier in the United States, with the deregulation movement of the 1970s and the Reagan presidency in the 1980s), though the ideology has taken a big hit from the global economic crisis triggered by the financial collapse of September 2008.

What we may call the efficiency theory of the common law is not that *every* common law doctrine and decision is efficient. That would be highly unlikely, given the difficulty of the questions that the law wrestles with and the character of judges' experience and incentives. The theory is that the common law is best (not perfectly) explained as a system for maximizing the wealth of society. Statutory or constitutional as distinct from common law fields are less likely to be efficient (see §19.2 *infra*), yet even they, as we shall see, are permeated by economic concerns and illuminated by economic analysis. Such analysis is also helpful in explaining such institutional features of the legal system as the role of precedent and the allocation of law enforcement responsibilities between private persons and public agencies.

But, it may be asked, do not the lawyer and the economist approach the same case in such different ways as to guarantee a basic incompatibility between law and economics? X is shot by a careless hunter, Y, and sues. The only question in which the parties and their lawyers are interested and the only question the judge and jury will decide is whether the cost of the injury should be shifted from X to Y, whether, that is, it is "just" or "fair" that X should receive compensation. X's lawyer will argue that it is just that X be compensated since Y was at fault and X blameless. Y's lawyer may argue that X was also careless and hence that it would be just for the loss to remain on X. Not only are justice and fairness not economic terms, but the economist is not (one might think) interested in the one question that concerns the victim and his lawyer: Who should bear the costs of *this* accident? To the economist, the accident is a closed chapter. The costs that it inflicted are sunk. The economist is interested in how to prevent future accidents that are not cost justified and thus in reducing the sum of accident and accident-prevention costs. The parties to the litigation may have no interest in the future. Their only interest may be in the financial consequences of a past accident.

This dichotomy is overstated. The decision in the case will affect the future, and so it should interest the economist, because it will establish or confirm a rule for the guidance of people engaged in dangerous activities. The decision is a warning that if one behaves in a certain way and an accident results, one will have to pay a judgment (or will be unable to obtain a

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judgment, if the victim). By thus altering the shadow price (of risky behavior) that confronts people, the warning may affect their behavior and therefore accident costs.

Conversely, the judge, and hence the lawyers, cannot ignore the future. The legal ruling will be a precedent influencing the decision of future cases. The judge must therefore consider the probable impact of alternative rulings on the behavior of people engaged in activities that give rise to the kind of accident involved in the case before him. If, for example, judgment is awarded to the defendant on the ground that he is a "deserving," albeit careless, person, the decision will encourage similar people to be careless, a type of costly behavior. Thus, once the frame of reference is expanded beyond the immediate parties to the case, justice and fairness assume broader meanings than what is just or fair as between this plaintiff and this defendant. The issue becomes what is just and fair for a *class* of activities, and it cannot be sensibly resolved without consideration of the future impact of alternative rulings on the frequency of accidents and the cost of precautions.

The "economic theory of law" and the "efficiency theory of the common law" should not be confused. The former tries to explain as many legal phenomena as possible through the use of economics. The latter (which is included in the former) hypothesizes a specific economic goal, that of economic efficiency in the Kaldor-Hicks sense, for a limited subset of legal rules, institutions, and so forth. The distinction will become clear in Chapter 11, where we'll see that federal labor law administered by the National Labor Relations Board, although explicable in economic terms, is not a system for maximizing efficiency; its goal, which is economic but not efficient, is to increase the incomes of unionized labor by cartelizing the labor supply.

§2.3 The Continental Approach

It would be a mistake to think economic analysis of law a strictly Anglo-American undertaking. The mistake is easily made, however, because, paradoxically, the Continental school limits—in the name of economics—the use of economics by judges. The Continental tradition in economic thinking about law, nascent in Aristotle's theory of corrective justice but fully developed in the writings of Max Weber and Friedrich Hayek, emphasizes the importance of law as a *neutral* framework for private conduct. The essence of corrective justice is that the judge is not to take account of the individual characteristics—the merits and demerits, the social standing, the deserts, etc. of the litigants. He is to judge the case, not the parties. Max Weber insisted in like vein that the judge's concern is with *formal* rationality—that is, with providing a framework that facilitates private ordering rather than

one that prescribes the terms on which people deal with each other.¹ And so with Hayek's insistence that judges should enforce customs, which is to say norms created by individuals from the bottom up, rather than laying down rules of conduct invented by the judges on the basis of their conception of sound policy, that is, imposed from the top down.² The Continental tradition assigns a narrow role to judges, a role reflected in the emphasis that the Continental legal systems place on detailed legislative codes as the principal source of law, rather than case law. That emphasis deprives judges of the significant policymaking role that they enjoy in a system of case law.

§2.4 Criticisms of the Economic Approach to Law

Economic analysis of law has aroused considerable antagonism, and not only among academic lawyers who dislike the thought that the logic of the law might be economics. A recurrent criticism is that the normative underpinnings of the economic approach are so repulsive that it is inconceivable that the legal system would embrace them, since law reflects and enforces fundamental social norms. But is the Kaldor-Hicks concept of efficiency really so at variance with those norms? It is certainly *a* component of the ethical system of our market-oriented society, and it may be the one that dominates the law as administered by the courts because of the courts' inability to promote other goals effectively.

Another recurrent criticism of the economic approach to law — although it is better described as a reason for the distaste with which the subject is regarded in some quarters — is that it manifests a conservative political bias.¹ We shall see that its practitioners have found that capital punishment deters, legislation designed to protect consumers frequently ends up hurting them, no-fault automobile insurance is inefficient, some discrimination is efficient, and much of securities regulation may be a waste of time. Yet economic research that provides support for liberal positions is rarely said to exhibit political bias. For example, the theory of public goods (see §16.4 *infra*) could be viewed as one of the ideological underpinnings of the welfare state, but is not so viewed; once a viewpoint becomes dominant, it ceases to be perceived as having an ideological character. The criticism also overlooks a number of findings of economic analysts of law, discussed in subsequent chapters — concerning right to counsel and standard of proof in criminal cases, bail,

§2.3 1. On the Aristotelian and Weberian conceptions of law, see Richard A. Posner, *Law, Pragmatism, and Democracy* 284-287 (2003).

2. Hayek's approach to law is discussed in §8.4 *infra*.

§2.4 1. Although not enough of one for some tastes! See, e.g., James M. Buchanan, *Good Economics — Bad Law*, 60 Va. L. Rev. 483 (1974); Richard A. Epstein, *A Theory of Strict Liability*, 2 J. Legal Stud. 151, 189-204 (1973).

Suggested Readings

products liability, the application of the First Amendment to broadcasting, the social costs of monopoly, damages in personal injury cases, the regulation of sex, responses to global warming, and many others—that support liberal positions. Perhaps the best evidence that economic analysis of law is ideologically neutral or balanced is the significant number of prominent practitioners of it who are decidedly liberal, such as Ian Ayres, Guido Calabresi, John Donohue, Gillian Hadfield, and Christine Jolls.

The economic approach to law is criticized for ignoring “justice.” One must distinguish between the different meanings of this word. Sometimes it means distributive justice—the proper degree of economic equality—and sometimes it means efficiency. We shall see, among other examples, that when people describe as unjust convicting a person without a trial, taking property without just compensation, or failing to make a negligent automobile driver answer in damages to the victim of his negligence, they mean nothing more pretentious than that the conduct wastes resources (see further §8.8 *infra*). Even the principle of unjust enrichment can be derived from the concept of efficiency (§4.14 *infra*). One should not be surprised that in a world of scarce resources waste should be regarded as immoral.

But there is more to notions of justice than a concern with efficiency. It is not obviously inefficient to allow suicide pacts; to allow private discrimination on racial, religious, or sexual grounds; to permit killing and eating the weakest passenger in the lifeboat in circumstances of genuine desperation; to force people to give self-incriminating testimony; to flog prisoners; to allow babies to be sold for adoption; to permit torture to extract information; to allow the use of deadly force in defense of a pure property interest; to legalize blackmail; or to give convicted felons a choice between imprisonment and participation in dangerous medical experiments. Yet all these things offend the sense of justice of modern Americans, and all are to a greater or lesser (usually greater) extent illegal. An effort will be made in this book to explain some of these prohibitions in economic terms, but many cannot be. Evidently there is more to justice than economics, and this is a point the reader should keep in mind in evaluating normative statements in this book.

Suggested Readings

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3. Harold Demsetz, The Primacy of Economics: An Explanation of the Comparative Success of Economics in the Social Sciences, 35 Econ. Inquiry 1 (1997).
4. Neil Duxbury, Patterns of American Jurisprudence, ch. 5 (1995).
5. David D. Friedman, Law's Order: What Economics Has to Do with Law and Why It Matters (2001).
6. Duncan Kennedy, Cost-Benefit Analysis of Entitlement Problems: A Critique, 33 Stan. L. Rev. 387 (1981).

8. Arthur Allen Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 Va. L. Rev. 451 (1974).

9. Nicholas Mercuro & Steven G. Medema, *Economics and the Law: From Posner to Post-Modernism and Beyond* (2d ed. 2006).

10. Thomas J. Miceli, *Economics of the Law: Torts, Contracts, Property, Litigation* (1997).

11. Richard A. Posner, *The Law and Economics Movement from Bentham to Becker*, in Posner, *Frontiers of Legal Theory*, ch. 1 (2001).

12. Steven Shavell, *Foundations of the Economic Analysis of Law* (2004).

13. *Chicago Lectures in Law and Economics* (Eric A. Posner ed., 2000).

14. *Ethics, Economics, and the Law*, 24 *Nomos* (1982).

15. *Foundations of the Economic Approach to Law* (Avery Wiener Katz ed., 1998).

16. *The Origins of Law and Economics: Essays by the Founding Fathers* (Francesco Parisi & Charles K. Rowley eds., 2005).

17. *Symposium: Law and Economics and Legal Scholarship*, 79 *Chi.-Kent L. Rev.* 345 (2004).