

Law and Social Economics: A Coasean Perspective

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Introduction

Iudex non calculat: prior to the 1960s, legal doctrine, in the common law tradition at least, had developed largely innocent of insights from economics. But during the subsequent half-century, the use of such insights to elucidate legal doctrine has become so widespread, albeit far more so in the US than in other jurisdictions (Landes and Posner 1993; Ogus 1995; Symposium 1991), that ‘law and economics’ is now one of the principal forms of jurisprudence, as is evidenced by the large number of existing introductions to the subject (Bowles 1982; Cooter and Ulen 2004; Hirsch 1988; Malloy 1990b; Mercurio and Medema 1997; Mercurio and Ryan 1984; Polinsky 1989; Posner 2007; Shavell 2004; Veljanovski 1982, 2006).

Much of the intellectual substance of modern law and economics derives from the application of microeconomic principles to legal reasoning, informed by what the main currents of economic analysis have argued since the time of Ricardo: that, compared to alternative institutional arrangements, properly functioning markets yield superior allocative outcomes in terms of aggregate wealth. Law and economics largely accepts the depiction of markets in neoclassical welfare economics, and uses perfect markets as the basic yardstick with which to compare alternative forms of allocating goods.

There is, of course, a serious and well-known problem in doing this. With suitably restrictive assumptions on how individuals and markets behave, the economic efficiency of perfect markets can be established with great rigour in modern welfare economics. But there is no hope that those assumptions can ever hold in any empirical situation. One therefore finds that in the history of economic thought there has run, parallel to the mainstream neoclassical tradition and in response to its abstraction from the detailed institutional context, various dissenting lines which stress the economic significance of that context. In particular, circa 1890-1920, an 'institutional economics' gained prominence in the US (Gruchy 1987; Hodgson 1998) in which detailed description of economic institutions, particularly of their legal constitution (Commons 1924), took precedence over abstract rigour (Veblen 1958).

It is this focus on the pivotal role of formal and informal social institutions that constitutes the distinguishing characteristic of social economics vis-à-vis mainstream economic thought. Social economists interested in legal issues have therefore displayed some scepticism towards fields such as law and economics which draw their analytical strength from the mainstream tradition, turning to institutionalism and its analysis of the sphere of law instead. What socio-economic scholars cannot afford to ignore, however, is the fact that law and economics has had a far greater impact on jurisprudence than socio-economic or socio-legal approaches (Ayres 1997). While we would thus like to acknowledge that the institutionalist literature is clearly relevant to those interested in law and economics (Goldberg 1976; Hovenkamp 1990; Medema, Mercurio and Samuels 2000), we will not further explore this literature, but refer the reader to Mark White's chapter in this Companion. Instead, we will focus our discussion on the obstacles which have hindered those sympathetic to social economic approaches to law grasping what is important in law and economics, the chief one of

which is a far too sweeping identification of law and economics with the unapologetically neo-liberal outlook of the (second-generation) Chicago school.

Current State of the Field

The field of law and economics obviously includes works of a general jurisprudential nature, but it has developed predominantly within the core law subjects. Posner's (2007) deservedly highly influential textbook, in which a general part merely precedes substantial treatments of the core subjects, clearly expresses this. Though this has been a major reason for the success of Posner's book, what immediately strikes those sensitive to socio-economic issues is how uneven the contribution of Posnerian law and economics to the various core subjects has been. Law and economics has obvious relevance to contract, where the action being discussed is 'economic' in an uncontroversial way, and some fine theoretical (Goetz and Scott 1980; Posner and Rosenfeld 1977; Trebilcock 1993) and empirical (Joskow 1985; 1987; 1988) work has been produced, particularly on the topic of remedies, which had been neglected in 'black letter' approaches to the law (Barton 1972; Birmingham 1970; Farnsworth 1970; Polinsky 1983; Shavell 1980). Law and economics' direct relevance extends to commercial and company law and related topics, and also straddles the 'private/public divide' to cover state intervention in economic affairs, so thereby obtains for a large sphere of modern society (Samuels 1971).

However, outside this sphere, the relevance of law and economics becomes less clear. For example, law and economics had one of its first great successes in the tort scholarship which Guido Calabresi developed following Coase's (1988: 96) insistence that the tort of negligence cannot seek to completely prevent accidents but must establish the socially acceptable level of harm (Calabresi 1970; Calabresi and Bobbitt

1978). But a disquiet has crept into one's reading of much of the subsequent scholarship. One now commonly comes across risk calculations conducted in purely economic terms (Posner 1972) which cannot fully capture what is at issue in negligence cases (Englard 1980; Steiner 1976; Veljanovski 1981: 125-33). The Learned Hand formula so widely elaborated in law and economics discussions of torts states that: 'if the probability be called P; the injury L; and the burden B; liability depends on whether B is less than L multiplied by P: ie whether $B < PL$ ' (United States v. Carroll Towing at 173 per Learned Hand J.). The power of Learned Hand lies in combining apparently contradictory considerations in a formula, but, of course, taken too far, this becomes misleading. The cost of personal injury is a matter of the value placed on the lives lost or damaged, and therefore what goes into L (and much of B) is a value judgement which economics cannot ultimately determine, as Learned Hand (Conway v. O'Brien at 612), Coase (1988: 154) and Calabresi (Calabresi and Hirschhoff 1972: 1080) themselves were perfectly well aware.

Turning to other subjects, disquiet can turn to outright concern. The application of law and economics to crime through the 'deterrence hypothesis' (Ehrlich 1973; 1975; 1979) turns on the claim that there is a 'market' for crime such that potential offenders can be deterred by setting penalties at such a level (including death) that the increase in the sum of the offender's utilities by offending is smaller than the decrease in that sum from threat of apprehension. This hypothesis clearly is a mathematically sophisticated version of Bentham's felicific calculus (Becker 1968: 209), and so is subject to the well known criticisms of utilitarianism. Of these, the most damaging is that the decision to offend is robbed of moral significance when it is reduced to a technical matter of choice of the optimal utility maximising action, though the very concept of a crime essentially involves an element of normativity. Basing criminal

law on the deterrence hypothesis would mean that much of it would turn into a sort of private law (Becker 1968: 198), where criminality would no longer be defined by the nature of the committed offence but by the inability of offended parties to seek recompense.

That it is unwise to flatten out all the moral and political issues involved in the definition of a crime as an act punishable by the state by a purportedly purely technical treatment of these issues should be obvious (Klevorick 1983). Take that subset of crimes that in effect redistributes resources from the relatively rich to the relatively poor. Since resources in those cases end up in the hands of those for whom they have a higher marginal value, it is not immediately obvious, on the 'economic' view, why these crimes would be defined as harms at all. It is by no means impossible to see why this is so, but Becker's (1968: 171) own reason, that the expenditure of resources in executing crimes is a deadweight loss which should be prevented, clearly fails to come to terms with what surely is the central contribution of modern criminology, that the 'labelling' of deviance is an explanandum, not an explanans.

Let us regard Becker's work benignly as an abstract exercise aimed at teasing out the intellectual and moral limits of pushing economic analysis beyond its traditional market context into other areas. From the perspective of social economics, this has helped to make these limits visible to a larger audience. Still, since the enormous contribution of the Chicago School now hardly needs to be stressed (Duxbury 1994; 1995), one can say without qualification that some contributions to Chicagoan law and economics have insufficiently considered whether the economic approach is appropriate to all the issues to which it has been applied, and have just driven on regardless.

This strain is typically identified with Richard Posner, the most influential writer on law in the common law world in the second half of the twentieth century (Baker 1975; 1978; 1980; Buchanan 1974; Campbell 1994; Heller 1976; Horwitz 1980; Hovenkamp 1995; Krier 1974; Leff 1974; Liebhafsky 1976; Malloy 1990a; Markovits 1975; Samuels 1976; Scherer 1977; Tribe 1972). Where some would have preferred a more circumspect reflection on the wider implications of law and economics (cf. Michelman 1979; Polinsky 1974), Posner has made the economic approach to legal issues pioneered by Becker and others easily comprehensible by translating it into widely accessible prose, largely doing away with the rather hard mathematical economics (Posner 1990: 367-70; 1993a). Posner has shown little hesitation in delivering applying the law and economics approach to a very wide range of issues both legal and tangential to law (Philipson and Posner 1993; Posner 1988; 1995), with at times astonishing audacity; as, for example, when pursuing the implications of Becker's (1960: 210-5) notion that children are 'consumer durables' through to the actual advocacy of running adoption as an auction (Landes and Posner 1978; Posner 1987).

Though clearly variants of some common arguments in jurisprudence, Posner's most important claims, to which he has given an original twist that has provoked much debate, have been that the common law is 'efficient' (Ehrlich and Posner 1974; Landes and Posner 1976; 1979; 1980; Posner 1973; 1993b) and 'wealth maximising' (Posner 1979b; 1980a; 1980b). The common law is claimed to display an intrinsic evolutionary tendency towards efficiency which makes it innately superior to legislation (Goodman 1978; Higgins and Rubin 1980; Priest 1977; 1980; Priest and Klein 1984; Rubin 1977; 1982; Rubin and Bailey 1994). It is also argued that the operation of the courts and common law reasoning can usefully be viewed as a market

evolving toward an equilibrium in adjudication, in that bad rules will give way because they, rather than better rules, produce costs which it is worthwhile to litigate to remove. The decisions reached by this process of continual improvement are, it has also been claimed, wealth maximising, for by confining itself to disputes thrown up by those who thereby demonstrate an effective demand for their solution, the common law addresses problems which did need solving, and therefore those solutions will enhance welfare. The point is that common law is preferable to legislation, which has no such intrinsic necessity to be efficient or wealth maximising, as it is 'politically' driven.

These notions of efficiency and wealth maximisation have led to some worthwhile proposals for the reform of legal procedure (Caspar and Posner 1976; Posner 1973; 1985). They have done so because they do hit on some important general points. That economic reasoning has usefully informed and should inform some legal decisions is why law and economics is worth bothering about. More than this, that the law does work itself pure is an idea with a long, productive history in jurisprudence. It is clearly valuable to have provoked such a volume of discussion of these themes. At the end of that discussion, however, it remains unclear what has been gained by the specifically Posnerian emphasis on efficiency and wealth maximisation.

The efficiency claim assumes a correlation between a party's ability to get to court and the welfare enhancing significance of the party's case, and justified doubt about that correlation is the main reason for state subsidy of legal advice and for the statutory reform (and much aggressive judicial shifting) of the substantive common law (Atiyah 1990:151-8; Michelman 1978; 1980). The introduction of realistic variables, such as, not entirely surprisingly, the ability to pay fees, into the evaluation of the efficiency claim shows that: '[t]he conclusion that disruptive precedents

automatically stimulate litigation that leads to their displacement by clearer decisions is a fragile one' (Bayes 1996: 2). What one needs to do is compare the fitness of the common law and legislation in specific cases, but though doing this will be assisted by healthy scepticism about the prospects of successful legislation, what it fundamentally requires is an open mindedness that can follow only by rejecting a compulsion to find the common law efficient which the efficiency notion elevates into some sort of ineluctable spirit of that law (Cooter and Kornhauser 1980: 157; Cooter and Rubinfeld 1989; Epstein 1980; Fried 1980; Greenawalt 1977; Kenny 1982: 50-5; Symposium 1980).

Posner began to proselytise the efficiency claim despite being conscious of 'our inability to explain in an entirely convincing way why the common law should be efficient' (Posner 1979a: 294), and, after seeing wealth maximisation subjected to a decade of calumny, to his credit he eventually allowed that: 'It may be impossible to lay solid philosophical foundations under wealth maximisation' (Posner 1990: 384). However, to a man of his stamp this hardly means that a congenial idea should be given up, and he has stuck to this one (Posner 1993c) by concluding that what is at fault is not wealth maximisation but thought. Wealth maximisation is right, Posner now outright asserts, 'and it would be a mistake to allow philosophy to deflect us [from this], just as it would be a mistake to allow philosophy to alter our views on infanticide' (Posner 1990: 384).

Main Issues: A Coasean Perspective

Though Posner must take the greatest credit for the wide reception of law and economics, it is essential to recognise that there are now many claimants to the use of law and economics beyond, or even in outright opposition to, Posner (Campbell 1994;

Symposium 1989a; 1989b; 1997). The question really is why social economists would want to claim law and economics rather than reject it, and for us, the basic answer to this lies in the work of Ronald Coase (Ellickson 1989a; Medema 1998; Schlag 1986), who has vigorously distanced himself from Posnerian law and economics (Coase 1993a: 96). Our contention is that law and economics represented by Posner is not only not exhaustive of law and economics outside Chicago, but also does not help us to come to terms with what Chicago has produced that is very worthwhile.

Coase himself held a view of the scope of economics sympathetic to Becker (Coase 1988: 12; 1994: 40-41; cf. Campbell and Harris 1993: 177-80). He has looked forward to economics unifying ‘contiguous disciplines’ (Coase 1977) along sociobiological lines so that all human action and higher animal behaviour can be analysed as ‘choice’ (Coase 1988: 2-4) within broadly competitive systems. This ‘unified science’ was to be mathematised after what Coase believes is the methodological essence of the natural sciences (Coase 1994: 14). He also believes that the American economy, alongside other advanced capitalist systems, is sufficiently competitive to allow successful application of the main insights from neoclassical price theory, albeit reformulated to properly address the costs of transacting (Coase 1937, 1960).

Coase has never substantiated his claim about the broadly competitive nature of the advanced economies, and his position on this point has plausibly been described as an ‘act of faith’ (Pratten, 2001, p. 629 n. 2). However, his claim for the competitiveness of the economy stands in sharp contrast to the carefully formulated methodological stance that informs his work, where the demand for empirical evidence holds a pivotal place. Coase’s basic contribution to law and economics, which requires a ‘new’ institutional economics of industrial organisation (Coase 1972,

1984; cf. Williamson 1975, ch. 1), is an economic analysis of institutions based upon a form of the regulatory perspective, albeit a form in which the considerable strengths of competitive forces, when they are furnished with a space in which to work, are duly recognised (Campbell 1996A, Klaes 2005, Campbell and Klaes 2005).

The general outlines of Coase's perspective on economic institutions are familiar territory in social economics. A brief summary shall suffice here. Coase's initial question was: if markets are efficient, why are there firms at all? Analysed as a question of allocative efficiency, the answer must be that, in certain circumstances, the firm is a cheaper way of organising production than the market (Coase 1988: 37-47). In other words, there is a cost attached to organising market transactions (cf. Klaes 2008). In particular, empirical markets have positive transaction costs and so must be weighed against alternatives, of which the firm and the state have been the most thoroughly analysed. After Coase, we can say that mainstream economic analysis, which typically assumes a market with zero transaction costs, should be balanced by an appreciation of the importance of the institutional structure of transactions, including those made in a market. This has given rise to, for example, a highly interesting law and economics of the corporation (eg Williamson 1996; 1993a, 1985, 1975). A related discussion of the concept of contract has emerged which is particularly rich because it has been able to draw on the criticism of the classical theory of contract within legal scholarship. The nascent formulation of an alternative 'relational' theory of contract (Campbell 1990b; 1996b; Campbell and Harris 1993; Feinman 1983) led by Ian Macneil (1974; 1980) is the most substantial development in legal doctrine to which this new economic institutionalism has so far contributed (Macneil 1978).

Having focused our discussion not on the established, if heterodox, institutional traditions in economics, but rather on teasing out what in mainstream law and economics may be valuable to social economics, we have thus come full circle, for we have identified a promising institutionalist agenda at the centre of the mainstream project itself. What is progressive in this ‘new’ institutionalism runs counter to the reversal of Coase’s thrust by his purported disciples in Chicago (Williamson 1987: 313-8; 1993b), and is in fact closer to the established institutional traditions in economics than the ‘new’ versus ‘old’ dichotomy might suggest (Rutherford 1994, Medema 1996; cf. Hutchison 1984).

The Chicago inspired reversal of Coase’s thrust has perhaps been most pronounced in relation to what has become known as the ‘Coase Theorem’, the principal way in which Coase’s work was first taken up in law and economics. As we have said, for Coase the fundamental aim of tort is the establishment of the socially acceptable level of harm. Take the perceived harm to a nearby settlement of environmental pollution emanating from a factory. According to Coase, any response to this harm should comparatively assess the net benefits to society associated with different levels of pollution, including the status quo. In a world of perfect markets and thus of zero transaction costs, this calculation would be best left to those markets, since they would ensure that the rights to pollute were allocated to their most highly valued uses. It is a feature of the operation of perfect markets that reaching an optimal allocation does not depend on the initial distribution of property rights. In other words, it would not matter whether the factory initially had a right to pollute, or whether those affected by pollution had the right to prevent the pollution, since either way, trade between both parties would ensure the optimum allocation of pollution

rights. It is this proposition that lies at the heart of what has been called the Coase Theorem.

We would not like to deal here with all the many meanings of this Theorem (eg Cooter 1987; Daly 1974; Zerbe 1980), nor with the very large theoretical (eg Frech 1973; 1979; Maloney 1977; Schulze and d'Arge 1974) and substantial empirical literature it has generated (eg Crocker 1971; Ellickson 1991; Johnston 1973; Kelman 1979; Vogel 1987). But even when concentrating on the most sensible meaning of the Coase Theorem, it is apparent that it has become a silly way of saying something initially quite simple and already part and parcel of received microeconomic theory, though prior to Coase not widely recognised as such. Expressing the irrelevance of the initial allocation of property rights under perfect markets by means of convoluted references to a Coase Theorem is therefore best abandoned (Cooter 1982; Fried 1978: chapter 4; Kennedy 1981; Mishan 1971; Regan 1972; Tribe 1973).

More importantly, however, far from encapsulating the central insight of Coase's contribution to the emerging law and economics literature (cf. Medema 1999), the point that, in a world of perfect markets with zero transaction costs, property rights are essentially without significance (provided that they are honoured in the first instance), is itself of no practical significance, since in economies as we know them, transaction costs are far from negligible, and hence the allocation of property rights is of the utmost importance. It is this point that constitutes Coase's core contribution to law and economics (Medema and Zerbe 2000; Medema 2002), and it is only recently that the implications of this insight are being taken seriously.

With the ubiquity of positive transaction costs, markets will always 'fail' if measured against the yardstick of perfect markets. Crucially though, non-market order has its own costs. Awareness of market failure must therefore be complemented with

an awareness of ‘government failure’ (Coase 1964: 195). Coase undoubtedly was anxious to stress the costs of regulation, but there is nothing in Coase’s framework of analysis *per se* that authorises a bias against state governance (Calabresi 1968:73; 1991:1211-2). What comparative institutional analysis does authorise is an informed choice between alternatives, none of which are costless, and valuable debate has taken place on these lines (Calabresi and Melamed 1972; Burrows 1981).

Law and economics has played a substantial part in calling into question the very size and structure of government. Making good the democratic deficit of the modern state and restraining that state’s growth have been increasingly identified as a problem of extending ‘quasi-markets’ to services formerly provided by the state (Osborne and Gaebler 1992), and of remodelling the remaining state apparatuses so that they mimic markets in order to facilitate public choice. The power of these works on property rights and their analogues lies in the way they have identified widespread regulatory failures and so have revived the plausibility of some market based solutions. Their shortcoming is that many of them tend to substitute for the careful evaluation of alternative governance structures recommended by Coase a blithe recitation of formulaic market solutions to complicated problems (Trebing 1976; Williamson 1986: 259). The exposure of the unworkability of some of these (Bryden 1978; McKean 1970) is proving to be a protracted and painful process (e. g. the debate in Shoup 1971; Demsetz 1971; Daly and Giertz 1975. Cf. Schlicht 1996).

Emerging Avenues: Institutional ‘Direction’

Coasean law and economics is based on an even-handed and empirically informed comparative institutional analysis of feasible market and non-market forms of economic coordination. It is important to realise that, on the conceptual level, Coase’s

work displays an essentially regulatory thrust, which, rather than proceeding from an a priori presumption in favour of market coordination, in fact accords primacy to what is best called the 'principle of institutional direction' (Campbell and Klaes 2005). To appreciate this point, it is necessary to re-examine Coase's mature work centred on 'The Problem of Social Cost' (Coase 1960) in the light of the central argument of his much earlier work, 'The Nature of the Firm' (Coase 1937).

'The Nature of the Firm' is widely acknowledged to be a compelling criticism of the conventional treatment of the firm in economics. A further dimension of the paper is much less well recognised: its intervention in the contemporaneous debate about the role of planning in socialism (Campbell and Klaes 2005). Coase's (1937) views of planning in the economic system are in fact in open opposition to the position that Hayek (1933, 1935) famously advocated in the planning debate: '[t]hose who object to economic planning on the grounds that the problem is solved by price movements can be answered by pointing out that there is planning within our economic system which is quite different from ... individual planning ... and which is akin to what is normally called economic planning' (Coase, 1937, p. 35). Coase is claiming that an entrepreneur controls his firm according to the same principles that a socialist planner would have to adopt when centrally administering the economy. Of course, this should not be read as a call for state planning to replace the market system. The analogy between the proposal to run the state as a big factory and the evident success of large capitalist corporations rather serves to qualify Hayek's scepticism regarding the possibility of successful large scale planning per se. What Coase pointed out was that 'direction', as a form of hierarchical (but entrepreneurial) planning, was evidently able to complement decentralised market coordination, due to the relative imperfections inherent in both modes of economic coordination.

Coase's (1937) emphasis on 'direction' emerges in 'The Problem of Social Cost' (Coase 1960) when he draws attention to another aspect of 'planning' that places it beyond the simplistic opposition between 'state' and 'market' (Campbell, 1999). Coase (1960) demonstrates that the definition of property rights is of crucial importance to markets that exhibit positive transaction costs. This leads Coase to define 'economic regulation' as 'the establishment of the legal framework within which economic activity is carried out' (Coase, 1977, p. 5). Hence, for Coase the question can never be whether or not to regulate a market, since the institution of market exchange as such rests on regulatory input, or 'institutional direction' (Campbell and Klaes 2005), i.e. 'direction' in the sense of Coase (1937), but applied to the market as an instituted entity.

This concept of regulation has important policy implications, for even when market governance is identified as the more efficient mode of coordination, such governance, according to Coase, relies on planned decision-making, not just at the level of any firms participating in the market, but also at the collective level. Crucially, though much less appreciated in this context, this collective planning goes beyond the definition of a regulatory framework for market exchange, which, traditionally conceived, would merely amount to an ex ante specification of the rules of the market game. Once fixed, these would define the possible moves within that game. But any revision, any binding re-interpretation of these rules, would amount to a move in that very game itself, with direct allocative implications. And this is, of course, what happens in the real world of permanent legislative change, ongoing clarification and redefinition of the law by the judiciary, and constant rewriting of administrative rules at all levels of governmental bureaucracy.

Coase's conception of the competitive economy addresses the fundamental conjunction between 'direction' and competition at all levels. According to 'The Nature of the Firm', effective planning must rely on competition. 'The Problem of Social Cost' adds to this that competition itself is unthinkable without planned decision making at the level of the collective about the specification and distribution of rights (logically prior to the market). Therefore, economic policy cannot extricate itself from a continuing process of institutional direction which underlines any regime even of market governance.

It is clear that the Coasean perspective does not as yet offer a comprehensive and fully formulated theory of institutional direction (Klaes 2005). The most promising developments at the intersection of social economics and legal studies seek to combine the institutional insights we have claimed are at the heart of modern law and economics with institutional traditions that, until recently, have largely operated in separation from, if not in opposition to, those law and economics. The rise of a neo-behaviourist economics is encouraging in this regard, but, as yet, it clearly does not go far enough to embrace social economic perspectives (Klaes 2007). Appreciation of the subtle relationship between the social and psychological dimensions of choice, and therefore also of transacting and contracting in the legal sense, will require acknowledgement of the role of the symbolic, expressive and outright narrative elements in the interaction between those dimensions and individual identity. Promising starting points for the required shift may be found in 'expressive' theories of choice (e.g. Anderson 1993) and their reception in socio-legal and in particular feminist studies (Hadfield 1998), provided one approaches them with a Coasean caution towards any 'paternalist' interventionism that remains residually embedded in at least some of these departures (Campbell 2005).

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