CHAPTER 11

ECONOMIC APPROACH TO LEGAL ISSUES: A REVIEW

The purpose of this chapter is to introduce the main issues in the economic analysis of law and their empirical applications. The major trends in the literature are analysed, based on the following theoretical areas.

1. The Legal-Economic Nexus
2. Positive Economic Analysis of Legal Issues
3. Normative Economic Analysis of Legal Issues
4. Economic Analysis of Law
5. Positive Economic Theories of Law
6. An Alternative Economic Approach

The history of a society can be viewed as a balancing effort between the natural order and economic environments. Law and legal institutions have profound influence on an economy and the economy in turn influences them. This inter-relationship between legal and economic forces can be traced from the very ancient times.
The economic approach to legal issues hinges on the faith among both legal professionals and economists that law and economics are complementary disciplines and that collaboration is potentially beneficial. Since the present study falls in the area of Legal Economics or Law and Economics it is useful to explore the basic legal-economic nexus and its applications.

The Legal-Economic Nexus

The legal-economic nexus embodies the idea that law and economy are not self-subsistent spheres; rather, economy is a function of law and law is a function of economy, and this functional relationship is one of simultaneous joint products. Economy is a function of law in the sense that law gives rise to rights, which in turn determine the allocation of resources, the distribution of income and wealth, and the power structure of society. Law is a function of economy in that many of the issues that come to law are economic in origin, reflecting attempts to change or protect certain
economic interests. All laws may have economic side effects. But the law relating to property, employment, production, trade, innovation, monopolies, distribution of income and consumer protection etc. may have explicit economic impact on the economy. Laws change economic infrastructure through legislation and direct the main economic activities viz. production, distribution, consumption and exchange. The concept of social control of business might be utilized as the point of departure for an analysis of legal-economic inter-relations and it can be observed that many problems which the courts undertake to solve in reality are economic problems more strictly than they are legal problems. The principles of economic analysis can aid our understanding of the law. Economic considerations are seen to have varied and widespread effects on the costs and benefits that prospective litigants may expect from litigation and on their decisions to

litigate or to settle out of court. Economic approach is also helpful to understand the significance of litigation costs, the practical problems of legal administration and the provision of legal services. The economic analysis of law involves three distinct but related enterprises. The first is the use of economics to predict the effect of legal rules. The second is the use of economics to determine what legal rules are economically efficient, in order to recommend what the legal rules ought to be. The third is the use of economics to predict what the legal rules will be. Of these, the first is primarily an application of price theory, the second of welfare economics and the third of public choice.

The marrying of economics and law is not new. Economic approaches to law can be found in the works of


Beccaria-Bonesara⁶, Bentham⁷, Marx⁸ and in the illuminating work of the American Institutionalist School, particularly of Commons.⁹ During the period between 1920 and 1960, the economic study of law and institutions fell into disrepute, although the intersection between law and economics continued in areas where the law had obvious economic objective or effects, eg. antitrust, competition, and trade policy and regulation. The resurgence in the economic analysis of law came from a number of sources. The work of Becker, G.S¹⁰ on discrimination although not specifically law related, provided the initial step in generalizing neoclassical economics to


⁹ Commons J.R. Legal Foundation of Capitalism, Macmillan, New York, 1924.

non-market behaviour. The early work of Alchian\textsuperscript{11} and Demsetz\textsuperscript{12} on property rights, Calabresi\textsuperscript{13} on tort and Coase\textsuperscript{14} on nuisance represent the building blocks on which the new law and economics now rest.\textsuperscript{15}

The economic approach to law is part of wider development which has resulted from the belief held by some economists that the core of economics, the theory of choice, is in principle applicable to all human and institutional behaviour.\textsuperscript{16} "When time and means for achieving ends are

\begin{itemize}
\end{itemize}
limited and capable of alternative application and the ends are capable of being distinguished in order of importance then behaviour necessarily assumes the form of choice........it has an economic aspect". The basic ideas contained in the economic approach to law are those of maximising behaviour or utility maximisation, stable preferences and opportunity cost.

Positive Economic Analysis of Legal Issues

Positive economic analysis is mainly used to make qualitative predictions and organise data for the empirical testing of these predictions.

The predictions of positive economic models must be interpreted with some care. These models only establish partial relationship. For example, one of the most common

---


predictions in economics is the inverse relationship between the price of a good and the quantity demanded. However, the statement must be read with an important caveat; it says that in practice the quantity demanded will decrease as price increases only if all other things remain constant in the system.

The methodology of positive economics as described above is one that lawyers find it difficult to accept. The main criticism which they are inclined to make is that the models are too simplistic and do not capture the full complexity of the legal phenomena which they seek to explain. This view usually expresses itself in the form of an attack on the unrealistic assumption of the economists' model. In response, the economists will argue that models are by their nature 'unrealistic', they are abstractions from not descriptions of, reality and that further more, it is not the models' assumptions that are to be verified but its predictions.

The techniques of positive economics are most relevant to "legal impact studies" or what Hirch has called
'effect evaluation'. Legal impact studies seek to identify and quantify the effects of law on measurable variables. An example of this application is the positive economic analysis of crime.

To the economist legal impact studies are a natural application of economic theory and empirical methods. They ask and attempt to answer the questions. What are the likely effects of the law? Have they actually occurred? Have the objectives of the law been attained? Moreover, the economist currently has a comparative advantage over the lawyers, because of his statistical training in answering these questions. Lawyers, when they venture into this area, discuss the effects of law in language and arguments which are based on unsupported empirical assumptions and their empirical observation lacks statistical rigor. There can be no doubt that impact studies have an important role to play in legal analysis and it is generally agreed that the law must

ultimately be evaluated in terms of its success in achieving its goals, and not purely in terms of its formal legalistic structure.\textsuperscript{21} 

\textbf{Normative Economic Analysis of Legal Issues}

Normative or welfare economics is concerned with the goals of private and social allocative efficiency. The aim is to identify situations in which these are not achieved and to prescribe corrective solutions.\textsuperscript{22} The analysis begins with the assumption that 'perfectly' competitive markets achieve private efficiency, that is an allocation of resources which is efficient from the point of view of the participants in the transactions. The relationship between the market and economic efficiency is often confused. The theory does not say that actual market is efficient. It only states that if a set of assumptions are satisfied, a market can operate

\textsuperscript{21} Op.cit.

efficiently.

"Perfect competition is an economic model possessing the following characteristics; each economic agent acts as if prices are given, that is each acts as a price taker, the product is homogeneous; there is free mobility of all resources including entry and exit of business firms, and all economic agents in the market possess complete and perfect knowledge."²³

It is on the basis of these assumption that economists' theorems concerning the private efficiency of the market and freedom of contract are based.

"A privately efficient allocation of resources will imply an allocation that is efficient from the point of society as a whole, i.e., that will be socially efficient, only if all of the consequences of reallocation of resources between uses are taken into account by the participants in the

transactions. In other words privately efficient allocations will be socially efficient as long as there are no external costs or benefits of a transaction. An external cost is an uncompensated loss that is imposed on individuals by some harmful activity. In the absence of external costs a perfectly competitive market system is socially efficient because it places every productive resource in that position in the productive system where it can make the greatest possible contribution to the total social dividend measured in price terms, and tends to reward every participant in production by giving it the increase in the social dividend which its co-operation makes possible. That is, society's resources are allocated to their highest competitively valued uses, and are sold at prices that reflect their marginal cost to society.

The prescriptive ability of welfare economics is based on the concept of market failure. When the assumptions

underlying the perfectly competitive market are not met, the market will either operate inefficiently or fail to exist. This departure from the ideal outcome of the perfectly competitive market is referred to as market failure and it provides the social efficiency rational for legal intervention. Although market failure may result from many imperfections viz. monopoly, imperfect information etc., the most important one for legal analysis is external cost. The most significant examples of external cost relate to pollution, crime and road accidents.

The existence of harmful activities is not necessarily sufficient for market failure to occur. In a paper, Ronald Coase in 1960 demonstrated that perfectly competitive markets could in principle control harmful activities efficiently. It is considered as one of the central ideas in the economic analysis of law. In the case

---

of pollution, in a perfect market the loss that pollution imposes on individuals would provide them with an incentive to bargain for a reduction in its level if they had no legal rights to compensation by the polluter. If the payment offered by the victims exceeded the costs to the polluter or reducing the level of pollution then the polluter would accept the victims' payment and decrease the pollution, because this could increase his profits. Voluntary bargaining of this type would continue until all the mutual gains were exhausted, which would occur at the socially efficient level of pollution. If the law required the firm to compensate the victims for the harm it imposed on them, the firm would continue to pollute up to the point at which the profit from an increment of pollution is exceeded by the increased compensation payment. When all of the profit from an increment in pollution has to be paid to victims as compensation the firm would cease to increase the level of pollution and at the point he would be inflicting the socially

efficient level of harm. This analysis is known as the Coase Theorem. It implies that the choice of property rights would not affect the social efficiency of the final outcome. But this analysis relies on a set of highly restrictive assumptions which includes the assumption that the cost of the transactions or cost of bargains is zero. In general, transaction costs include the costs of identifying the parties with whom one has to bargain, the costs of getting together with them, the costs of the bargaining process itself, and the costs of enforcing any bargain reached. Even in the context of zero transactions cost the choice of property rights would be expected to alter the distribution of income and this in turn would determine the particular socially efficient resource allocation that the bargaining process would bring about.28

The Coase Theorem has had a significant influence on the economic approach to law. Its popularity has been due to

the fact that by describing an idealized market situation it focuses attention on the obstacles to socially efficient markets, the causes of market failure. These causes tend to be grouped under one issue, transaction costs, but they include a variety of frictions that impede the exchange of the kind envisaged by the model of the perfectly competitive market. These frictions include the costs of obtaining information, and of searching, negotiating and enforcing agreements.

When transactions costs exist the law is unlikely to be allocatively neutral, it has an efficiency role to play. This is true whether the law in effect provides a legal right basis for the market or bargaining process to operate upon to determine the level of external costs, or whether the law directly determines the level of external costs by establishing legal rights where the market is not operative with respect to such costs.

In principle, Coase Theorem can be interpreted merely as the statement that socially efficient levels of external costs depend, in the case of pollution for example, on the balance of the costs of polluting and the costs of not
polluting. This says nothing about the operability of markets. Coase originally presented the theorem in the context of bargaining over external costs. But many economists and lawyers have since explored the implications of the theorem on the context of the analysis of market solutions. Much of his literature has been neoclassical in style and pro-market in conviction and has tended to favour common law and damages measures designed to give the ever-willing market a gentle nudge in the direction of social efficiency. More recently there has developed a considerable degree of scepticism concerning both the suitability of the neoclassical model of the behavior of firms for the analysis of many problems in law and economics and the relevance of the free market to the control of external costs in the real world of poor information and uncertainty. This scepticism has led first to the presentation of analysis which is referred as neo-institutional, that focus primarily on the organisation of transactions when transaction costs are significant, and secondly to the investigation of statutory methods of control

intended to deal with market failure or to achieve other social objectives.  

The normative approach to the economics of law can be illustrated by looking first at the work of Calabresi, on accident law, and then at a recent attempt to use the notion of efficiency to provide a theory of legal rights and duties.

The efficiency approach to law usually proceeds by stating the objective of the minimization of the total social costs of an activity. According to Calabresi "the principal function of accident law is to reduce the sum of the cost of accidents and cost of avoiding accidents." This goal presupposes three things that all losses can be expressed in monetary terms, that accidents can be reduced by devoting more resources to accident prevention and that those involved in or


potentially involved in accidents are sensitive to cost pressures.

Although many people would accept the proposition that accidents can be reduced by committing more resources to preventive measures, there is lively controversy over whether the type of cost pressures which are generated by damages awards will be effective in encouraging greater care.

The development of normative economic approach to tort is also interesting for the more general trend it reflects. Economics has been used in two distinct areas that correspond to the two dominant function of tort, namely, compensation and deterrence. The 'older' economic approach examined in great detail the operation of the tort system as an imperfect compensation scheme. This literature is

generally marred by its tendency to identify economics with purely financial considerations and to assess the efficiency of accident law solely in terms of minimising the administrative costs of providing compensation. The 'new' economic approach, on the other hand, ignores the compensation goal and assumes that the aim of tort is to promote the efficient allocation of resources to accident prevention.

The models of economists frequently assume that the legal system is costless, that individuals are aware of the law, and that the court is capable of dividing all of the information required to make the efficiency calculation. In spite of these limitations, the literature has made an important contribution to theoretical analysis by showing that legal standards embodying cost-benefit type comparisons have a clear economic rationale. However, it conveys a false impression that efficient doctrine in an abstract world necessarily means efficient law in some empirically relevant context.\footnote{Posner R.R., Economic Analysis of Law, 2nd edn. Boston: Little-Brown, Ch. 6, 1977.}
An unfortunate feature of the economic approach to legal issues has been the tendency of many studies to ignore the relationship between social efficiency and the distribution of income and wealth\textsuperscript{36}. If a perfectly competitive market is to operate efficiently, in addition to the assumptions, we need a clearly defined initial distribution of income and wealth which is legally protected by a set of property rights. The features of socially efficient market outcome to a great extent depend on the initial distribution of income, because of each different distribution of income there is a different socially efficient outcome. The desirability of social efficiency as a goal requires a value judgment as to the justness of the underlying distribution of income and property rights\textsuperscript{37}. It is worth substantiating this idea because of the confusion that has recently arisen in the literature. It has been asserted that


legal rights should be assigned to those who value them most highly. This dictum is seen as establishing efficiency as a 'comprehensive and unitary theory of rights and duties'. But this claim fails for a number of reasons. First, the valuation of rights in terms of money is itself determined by the bundle of rights the individual already possesses which in turn determines the individual's wealth. Secondly the contention that corrective rights should mimic perfect market outcomes begs the question. If rights are to be assigned to mimic perfect market outcomes we must know what structure of rights that outcome was based on. An efficiency theory of legal rights is admitted by its advocates to be a very limited theory: it is a theory that the law seeks to optimize the use and exchange of whatever rights people start out with.


Economic Analysis of Law

There are advantages and disadvantages of the economic approach to legal issues.

The major source of disagreement between economist and academic lawyer over the economic analysis of law relates to the nature and value of model building. Lawyers and economists approach problems in different ways.

The lawyer is concerned with the particular, with factual details and with formal legal propositions supported by argument. The economist, on the other hand, is concerned with generalities, prefers to sweep away details and his analysis tends either to be partial or to stress the numerous considerations which apply to a particular problem. The economic approach seeks to connect ends to means, to provide generalizations that can be used to frame policy and to evaluate legal doctrine and procedure, to reveal the

trade-offs between goals and to trace through the interrelationships between different laws and private behaviour.\textsuperscript{41}

Frame work or model building has two short-comings. The first is that models can be mistaken for the total view of phenomena, like legal relationship which are too complex to be painted in any one picture. The second is that models generate categories in which one may be forced to accept situations which do not truly fit. However, there are compensating advantages for models. The economic approach places at the forefront of discussion the need to choose and the costs and benefits of alternative choices, which must always be a relevant consideration where resources are limited. Lawyers may not always consider the different type of costs involved in legal activities. Economics tells us that nothing is free from society's viewpoint. The decision to litigate for example, consumes economic resources that will then be unavailable for other uses and the economic approach

can assist in determining the real value of money. As Leff has put it, "the central tenet and most important operative principle of economic analysis is to ask of every move (1) how much will it cost; (2) who pays; and (3) who ought to decide both questions". 42

A common criticism is that the utility maximization hypothesis is tautological and therefore it should not be considered that its apparent 'explanatory' power is great. In a purely formal sense this criticism is not correct. The utility maximisation hypothesis is based on a set of axioms. In its predictive use this hypothesis is capable of falsification if the predictions derived from it do not confirm to experience.

The rationality assumption has been responsible for revealing some important consequences of legal change. People do not respond passively to the law, nor mindlessly obey it, but they adapt to the changed costs and benefits that it

brings about. This may be in the desired direction, but it may also lead to perverse effects that subvert the objectives of law. The economic approach not only provides an integrated treatment of effect of legislation but has also been responsible for drawing attention to the more subtle and hitherto unrecognized economic effects.

Another attractive feature of economics is the sophisticated level of its statistical analysis and its ability to quantify the impact of law. Although all legal questions are not susceptible to statistical analysis, certain legal impact, for example, economic impact of private property litigation, can be statistically analysed. The lawyer's approach to empirical analysis is mostly confined to the examination of trends in legal activities.

Against these attractive features of the economic approach, there are some deficiencies in this approach.

---

The first is the concentration on efficiency. This conveys the misleading impression that the sole contribution of economics is to analyse the law in terms of efficiency where as economics has elsewhere been applied fruitfully to the discussion of justice, distributional and political question 44.

If there is a conflict between efficiency and justice, the nature of the difference can be illuminated by economic analysis. Since the attainment of justice involves the use of economic resources the economic approach can contribute to normative discussions by providing information on the cost of justice 45.

The alternative view has been stated by several prominent exponents of the economic approach to law, that efficiency and justice are synonymous "second meaning of

45 Thuron, Economic Justice and the Economist 1973, p.120-129.
justice and the most common, argues Posner, is simply efficiency". While this conventionally removes the need to consider questions of justice, it does so by refusing to accept that there are widely held notions of justice and of just protection from interference that do not coincide with efficiency.

The efficiency approach focuses solely of outcomes and assumes that the process by which they are achieved are not valued by individuals. The law is treated as a factor of production like a machine, which is efficient if it maximizes the economic value of goods and services. The suppression of processes and other intangible factors in economics is largely the result of the economist's urge to make things commensurable in terms of the common denominator of money. But at a conceptual level the efficiency calculus cannot sustain this distinction between means and ends if both are independent sources of utility. If legal processes or the way

of doing a thing yield utility, then individual will be willing to pay for these (through the reduced efficiency of the outcome), and if they are not incorporated into the efficiency calculation it will be both incomplete and misleading. It implies that for commenting on the efficiency of a law by merely doing a cost-benefit analysis of its impact on the economic value of goods and services alone is not sufficient, the value people place on the legal process must also be included.

Now we may turn to discuss the peculiar problems encountered with lawyers' use of economic analysis for the purpose of describing and explaining the law.

Positive Economic Theories of Law

Lawyers tend to use economic to provide descriptive and comprehensive theories of law. The economics of crime is

mainly predictive in nature. But when the economic theory of crime is used to explain the structure of the criminal law it performs poorly.\(^50\).

In contrast to the experience with criminal Law, economics has had a considerable impact on legal scholarship on tort and contract. The major reasons for this are that the bulk of literature in the positive economics of law does address questions that are central to legal scholarship, and that it uses economics not to predict the impact of law, but to describe and explain the law for providing it with an economic rationale.\(^51\). According to Friedmans\(^52\) "predictive economic theory has no substantive content".


\(^{51}\) Ibid, p. 18.

The descriptive use of economics must be judged by a different criterion, for two reasons. First, since its purpose is to describe the existing system of law, rather than to predict the impact of changes in the law, it must be given substantive content. Secondly, the aim should not be to discover the nature of a hypothetical legal structure that would satisfy the requirements of efficiency and use it as a standard by which to judge real law, but to see to what extent the existing law is constant with the notion of efficiency.

The efficiency theory of the common law, which was first advanced by Posner in a paper entitled "A Theory of Negligence", centres on the hypothesis that the implicit goal of the common law is to promote an efficient allocation of resources. In a largely descriptive analysis Posner attributes to the doctrines, remedies and procedures of the common law economic interpretations that suggest that the efficiency content of the law is high. In the area of tort,


54 Ibid., 1974, p.757-782.
more specifically in the area of negligence, the determination of damages as a remedy and the calculation of damages etc. are based on economic logic.\textsuperscript{55}

\textbf{An Alternative Economic Approach}

An approach of the institutional economics of John Commons\textsuperscript{56} was based on market process. This revitalization follows Commons by making not the individual but the transaction the basic unit of analysis. For Commons the transaction represented the 'unit of activity' that possessed the three essential principles of conflict, mutuality and order that he saw as necessary to correlate law and economics. The transactional approach, alternately called neo-institutional, relational or transaction cost approach, is still in its formative stages. However, the work of


Williamson\textsuperscript{57}, Goldberg,\textsuperscript{58} the related legal discussions of Macneil\textsuperscript{59} on contract, Calabresi\textsuperscript{60} on tort and Austrian economic critiques like Little Child\textsuperscript{61} and Rizzo\textsuperscript{62} all provide a complementary framework that deals apparently with the difficulties of the neoclassical market approach. Unlike the market based approach the neo-institutional approach does not assert that the law or institutions are efficient, but as usually only attempts to identify the efficiency attributes of various institutional arrangements, and to hypothesize that there is a tendency for institutions to evolve to exploit opportunities for improving the efficiency with which market

\textsuperscript{58} Goldberg V.P., Regulation and Administered Contracts, Bell Journal of Economics, 7, No.2, 1976, p.426-448.
and non-market goals are followed.

It is due to the work of pro-market economists and lawyers that a large proportion of the economics of law literature has related to methods of fostering markets rather than finding alternatives to them when markets have failed. An example of this is the debate on liability rules and bargaining solutions to external cost problems, when most of the serious external costs relate to air and water pollution. These problems can't be solved by market.\(^{63}\)

There has been developing an increasing interest in the scrutiny and evaluation of the operation and impact of statute laws in a number of areas, for example, pollution control, safety and work legislation, consumer protection, habitation law, planning and social security law.\(^{64}\) In addition it has been recognized that the law in practice may differ significantly from the law on the statute books, so

\(^{63}\) Ibid

\(^{64}\) Billor J.C. and Yandle B., (eds.), Benefit-Cost Analysis of Social Regulation, Washington D.C., American Enterprise Institute
that a greater emphasis has been placed on the performance of enforcement procedures.

The main trends in the economics of law shows that it can provide insights in places where traditional legal analysis fails to penetrate. It is the essentially complementary nature of the two disciplines that makes as optimistic that collaboration between lawyers and economists will be increasingly fruitful in the future.

The sound theoretical legal economic nexus highlights the relevance of the present study on Economics of Justice in Kerala with reference to the Private Property Litigations. The development in the literature on economics of law helps in properly evaluating the economic value of the private property litigations by using the model developed for the study.

---
