0200
HISTORY OF LAW AND ECONOMICS

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Abstract

The idea of applying economic concepts to gain a better understanding of law is older than the current movement, which goes back to the late 1950s. Key insights of law and economics can already be found in the writings of the Scottish Enlightenment thinkers. The Historical School and the Institutionalist School, active on both sides of the Atlantic between roughly 1830 and 1930, had aims similar to the current law and economics movement.

During the 1960s and 1970s the Chicago approach to law and economics reigned supreme. After the critical debates in the United States between 1976 and 1983, other approaches came to the fore. Of these, the neo-institutionalist approach and the Austrian approach, both corresponding to schools within economics proper, are worth watching.

Law and economics has progressively found its way to countries outside the United States. From the mid 1970s onwards it reached the English speaking countries, then other countries as well. In no country has law and economics had as much impact as it has in the United States.
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1. Introduction

The economic analysis of law, or law and economics, may be defined as 'the application of economic theory and econometric methods to examine the formation, structure, processes and impact of law and legal institutions' (Rowley, 1989b, p. 125). It explicitly considers legal institutions not as given outside the economic system but as variables within it, and looks at the effects of changing one or more of them upon other elements of the system. In the economic analysis of law, legal institutions are treated not as fixed outside the economic system, but as belonging to the choices to be explained.

This approach is advocated not merely for legal rules with an obvious link to economic realities such as competition, economic organisation, prices and profits, and income distribution, which translate into competition law,

industrial regulation, labour law and tax law. Law and economics has the ambition of applying the economic approach not merely to these areas of economic regulation readily associated with economics, but to *all* areas of law, in particular to the core of the common law.

The current incarnation of law and economics originated in the United States in the late 1950s and found acceptance amongst the legal community from the 1970s onwards, as a result, in particular, of the writings of Richard A. Posner. It has been presented at times as an altogether novel introduction of concepts and methods of a neighbouring science into law, in that it addresses questions across the entire range of legal subject matter, including much non-market behaviour (Posner, 1975a, p. 759).

This view may overstate the originality of the movement. Recent historical research has shown that already in nineteenth century Europe, there existed a broad scholarly movement whose ambition was to show how a better understanding of law could be gained by using economic concepts and methods (Englard, 1990; Pearson, 1997). Holmes's oft-cited exhortation to legal scholars, in 1897, to turn to economics and statistics: 'For the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics' (Holmes, 1897, p. 469) may have pulled the American branch into the limelight. But if Hovenkamp (1990) is to be believed, Holmes merely gave voice to a development which had already reached the United States in the 1880s and continued well into the twentieth century. This movement is known - rather too little as Pearson contends (1997, pp. 159-161) - as institutional economics (Duxbury; 1995; Pearson, 1997, p. vii; Medema, 1998). But this is not the only connection between law and economics prior to the current movement. At the University of Chicago, where the current movement originated, there was, from 1940s onwards, an earlier infusion of economic ideas into law, associated with the name of Aaron Director.

It is instructive to look at these earlier branches of law and economics to understand the reasons for both their initial attraction and their ultimate decline. In a broader context, the question has recently been raised why the winds turned and intellectual leadership in legal theory moved from Continental Europe to the United States (Mattei, 1994c). For the current movement, a deeper historical perspective should make one wary of the belief that present understanding provides a definitive account of the legal system. Such caution is in order at a time when, in one scholar's words (Ellickson, 1989, p. 26), 'law and economics is no longer growing as a scholarly or curricular force within the leading American law schools. Instead, it is simply holding previously won ground.' Study of the earlier movements may point us to the research agenda to adopt if we wish the current one to continue.

Law and economics borrows concepts and methods from economics proper. It inherits the controversies to which they are subject in the mother discipline. In

economics proper, the question has recently been raised of what has gone wrong in the discipline (Boettke, 1997): even half a generation ago the neoclassical model reigned supreme and virtually unquestioned; now economists appear divided on their theoretical framework.

This debate spills over into the economic analysis of law. Since the 1980s, gone is the beautiful consensus about method and agenda, generated by the first editions of Posner's textbook (1972b, 1977) solidly based on neoclassical economic insights. Besides the Chicago approach, various shades of institutional (Benson, 1994; Mercuro and Medema, 1997, chs 4 and 5; Samuels, 1990, 1998a, 1998b, 1998c; Samuels and Mercuro, 1984; Samuels ans Rutherford, 1998; Samuels and Schmid, 1981; Schmid, 1989a, 1989b, 1994; Teijl and Holzhauer, 1990) or neo-institutional (Alston, Eggertsson and North, 1996; Coase, 1984, 1992; Eggertsson, 1990; Furubotn, 1989, 1993; Furubotn and Richter, 1992, 1997; Knight, 1992; Langlois, 1986; Medema, 1989; Mercuro, 1989; North, 1984, 1986, 1991, 1993, 1994, 1995, 1996; Williamson, 1985, 1986, 1996) approach to law and economics have come to the fore, as has the Austrian approach (Barnett, 1992, 1998; Benson, 1994; Boettke, 1994; Bouckaert, 1984; Boudreaux, 1994; Hayek, 1973, 1976, 1979; Kinsella, 1995; Leoni, 1991; Lepage, 1985; Ogus, 1989; Rizzo, 1979b, 1980a, 1980b, 1980c, 1980d, 1981, 1982a, 1982b, 1985, 1987; Rizzo and Arnold, 1980, 1987; Rowley, 1989a, 1989b; Rowley and Brough, 1987; Schmidtchen, 1993; Teijl and Holzhauer, 1997; Thornton, 1991; Vanberg, 1998a; Voigt, 1992; Wonnell, 1986). These approaches emphasise the interest of historical studies, which received a powerful endorsement when the 1993 Nobel prize for economics was awarded to two economic historians, Douglass North and Robert Fogel (North, 1994).

Since Posner's initial impetus, the sources from which the law and economics movement may draw inspiration have broadened. They now also include the public choice school, bringing an economic approach to political processes, and game theory, which has become a rallying point for the social sciences in that it applies rational choice ideas to the interaction of two or more actors, or indeed a multitude of them with the attendant opportunities for free-rider and hold-out strategies.

For the purpose of exposition, it will be helpful to divide the history of law and economics into phases. Duxbury (1995, p. 340) cautions against the danger of historical reductionism in such periodisation. Simplicity of exposition makes it nonetheless worthwhile in my view.

2. Precursors

Economics as a science may be considered to go back to the late eighteenth century, when Adam Smith wrote his *Inquiry into the Nature and Causes of the*

Wealth of Nations as part of what later came to be called the Scottish Enlightenment (Robertson, 1987). Well before his time one finds writings in which human behaviour is analysed as the result of rational choice, or which undertake rational calculation of the costs and benefits of particular policies or rules, and offer practical economic policy advice to rulers of the day. In this light Macchiavelli (1961; see Pearson 1997, p. 19) should count as an early precursor of law and economics, as should the Cameralists active in Germany from the fifteenth untill the early nineteenth century (Backhaus and Wagner, 1987; Pearson 1997, p. 11). Ridley (1997, p. 54) submits that Hobbes already clearly understood the prisoner's dilemma.

In Adam Smith's own time, David Hume had a clear grasp of the intricacies of human interaction such as game theory formalises them in our day. In his *Treatise* ([1740] 1978) he presents law as a set of conventions which humans have learned to conform to in order to make co-operation possible in a world of scarcity and limited foresight. He understands the paradox of collective action, in his example of the draining of the meadow (Hume, [1740] 1978, Bk 3, Pt 2, Sec. 7) and uses it to justify the provision of some collective goods by the State. Hume's *Idea of a Perfect Commonwealth* provides keen insights in the dynamics of a federal system, as public choice articulates it today ([1777] 1987). Rousseau similarly understood the game of prisoner's dilemma in his description of the stag hunt ([1755] 1971, p. 207).

Adam Smith himself, in his *Inquiry*, saw the crucial role of speculators and the effects of government intervention in the price system and of protectionist policies ([1776] 1937, Bk IV, Ch. 5, p. 493). Speaking of a company of merchants establishing a new trade, who are granted a temporary monopoly, he observes that '[a] temporary monopoly of this kind may be vindicated upon the same principles upon which a like monopoly of a new machine is granted to its inventor, and that of a new book to its author' ([1776] 1937, Bk V, Ch. I, Pt III, Art. 2nd, p. 712). Law is seen here, in utilitarian fashion, as contributing to the public good, indeed as an instrument for promoting it. The incentive effect of law is obvious in the following passage: 'For if the legislature should appoint pecuniary rewards for the inventors of new machines, etc., they would hardly ever be so precisely proportiond to the merit of the invention as this is. For here, if the invention be good and such as is profitable to mankind, he will probably make a fortune by it; but if it be of no value he also will reap no benefit' (Smith, [1776] 1982, p. 83).

Other thinkers of the late eighteenth century also displayed insights now considered part of law and economics. Prominent amongst these are Beccaria and Bellamy ([1764] 1995), for the dissuasive effect of criminal sanctions, and Bentham, in his calculus of pains and pleasures, applied to a variety of legal questions (Bentham, [1789] 1948). But all of these writings did not amount to a systematic understanding of law through a rational choice model.

3. The First Wave

Such an understanding was the ambition of what may be called the first wave of law and economics. This movement, if indeed it may be properly called that, given the relative heterogeneity of viewpoints, was European in origin, but reached the United States through the (older) institutionalist movement. It has been given prominence in a recent historical study entitled *Origins of Law and Economics* by Heath Pearson, with the subtitle *The Economists' New Science of Law Movement 1830-1930* (Pearson, 1997, p. 44, referring to earlier studies). What follows relies mainly on this study to describe the movement(see also Hutter, 1982; Englard, 1990). For the American branch, the (old) institutionalist school, useful sources are Duxbury (1995, pp. 316-330), who questions whether it is proper to speak of a movement (Duxbury, 1995, p. 318), as well as Hovenkamp (1990), Medema (1998) and Mercuro and Medema (1997, Ch. 4).

The key question the proponents of the movement addressed was how property and other rights were determined, historically and functionally, across different societies. The earlier answer of sixteenth and seventeenth century philosophers, that these rights were given as a matter of natural law, logically prior to any positive legal system, seemed to them unsatisfactory. It could not account for the variations of rights in time and space. Changes in property rights, in their view, should be expected to reflect changes in economic conditions. What they were seeking to develop was 'an explanatory science of rights' (Pearson, 1997, p. 33).

The movement originated amongst economists. Prominent amongst them were the Germans belonging to what came to be known as the 'German Historical School' (Pearson, 1997, p. 95). The conjunction of political economy and law in the discipline called *Staatswissenschaft* may have stimulated their contribution. There were contributions in many other countries as well: Austria, Belgium, England, France, Italy, the Netherlands, the United States. Pearson (1997, p. 170-175) lists more than one hundred names of participants in the movement. Only some of these are still remembered today: John R. Commons, Gustave de Molinari, Carl Menger, Gustav Schmoller, Werner Sombart, Adolph Wagner (Hutter, 1982).

The core thesis of the movement, that rights were contingent upon economic and social conditions, came to be widely accepted. When Marx insisted on it in his writings from 1859 onwards, he was expressing accepted wisdom. By the 1870s the movement gained foothold amongst legal scholars: Wilhelm Arnold, Otto von Gierke, Rudolph von Jhering, to mention a few in Germany, and Henry Maine ([1861] 1977), in England. Englard (1990) has drawn attention to the contribution of the Austrian scholar Victor Mataja to the economic analysis of liability for damages a century ago. Scholars in other

countries were drawn to the movement as well and one may properly consider it cosmopolitan (Pearson, 1997, p. 33).

The adherents of this approach engaged in a variety of historical studies of rights in land and contractual arrangements for its exploitation. The studies showed how the institutions varied, for instance according to the density of population, the quality of the soil and the type of exploitation. They investigated what was subject to individual rights, what was left as commons and what sharing rules were applicable to the latter. One finds here considerations of relative transactions costs familiar in current law and economics studies, but also acceptance of the wisdom embodied in institutions which have evolved in the course of history, a theme reflected in Hayek's work in our day (Pearson, 1997, pp. 43-70). The explanations proposed may be properly called economic in that they rely on costs and benefits to individuals, who choose rationally in an environment of scarce resources. These are to this day the pillars of economic reasoning.

What caused the decline of the movement? Pearson (1997, p. 131) attributes it mainly to two factors. One is the increasing specialisation amongst social scientists, which led economists to restrict their attention to matters unquestionably related to markets. They studied the workings of the economy within a framework of given legal institutions.

The other factor were the excessive claims made for the movement and the increasing fuzziness of the 'economic' methodology on which it relied. In part, this may be due to the poor state of development of economic science itself: the 'marginalist revolution' took place only in the last part of the nineteenth century. Perhaps as a result, some members of the movement let themselves be tempted to explore explanations that strayed increasingly away from the strictly individualist rational choice model to 'holist concepts' such as 'national spirit', 'socio-psychic motives' and 'collective will' (Commons) or to 'the psychological-moral life of nations' (Schmoller) (Pearson, 1997, pp. 72, 153, 158). As the economics profession specialised, such explanations seemed more and more heretical to economists (Pearson, 1997, p. 153).

The difficulty is well expressed in what Blaug has to say on institutionalism, which is at the root of the American branch of the first wave of law and economics: 'A much better description of the working methodology of institutionalists is *storytelling* ... Storytelling makes use of the method that historians call colligation, the bundling together of facts, low-level generalizations, high level theories, and value judgements in a coherent narrative, held together by a glue of an implicit set of beliefs and attitudes that the author shares with his readers' (Blaug, 1980, p. 126). Coase is even more dismissive: 'The American institutionalists were not theoretical but anti-theoretical, particularly where classical economic theory was concerned.

Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire' (Coase, 1984, p. 230).

The movement fared no better with the legal community than it did with economists. The conclusions which its proponents were able to draw from their model and from their historical investigations did not convince lawyers. The legal community remained of the view that economic factors alone could not account for the fullness of the 'tendencies and aspirations of the human soul' reflected in the law (Pearson, 1997, p. 144, quoting Del Vecchio). This is surely a misreading of the essence of economics (methodological individualism and instrumental rationalism), but one whose persistence must be laid at the doorstep of the proponents of the movement, be it the historical school (Germany) or the (old) institutional school (USA).

By the 1930s, the movement faded away as a distinct contribution of economics to the understanding of law, to make room for the sociology of law and legal realism. Some of its contributions nonetheless live on: Menger's through Hayek in modern neo-Austrian thinking and in the evolutionist theory of Nelson and Winter (1982); Commons' ideas find an echo in Williamson's work (1985, 1996) and live on in that of modern institutionalists such as Samuels (1971, 1972, 1974, 1975, 1976a, 1998a), Samuels and Schmid (1981) and Schmid (1978, 1989). The importance of institutions as constraints on economic activities has been underscored in the 1991 and 1993 Nobel prize lectures in economics: Ronald Coase (1992) and Douglass North (1994).

4. The Second Wave

It will be helpful, in dealing with the current law and economics movement, to distinguish several periods: the beginnings, paradigm proposed (1958-1973), paradigm accepted (1973-1980), paradigm questioned (1976-1983) and the movement shaken (from 1983 onwards).

4.1 Beginnings

As early as the 1930s, there are studies pointing to a revival of the link between law and economics on a different footing. Some of these have remained part of modern day law and economics. In the UK, Arnold Plant looked at the economics of intellectual property (1934a, 1934b and 1953); Ronald Coase, his pupil (Coase, 1994, pp. 176 f.) and one of the founders of the current movement, published as a young researcher his famous study on the nature of the firm (Coase, 1937). But the veritable revival of law and economics occurred at the University of Chicago, in 1940s, under the inspiring leadership of Aaron Director (Duxbury, 1995, p. 341; Levi, 1966; Meltzer, 1966). Economic science

itself was by that time undergoing change which led to the 'neo classical synthesis'. The finest overview of this period is unquestionably Duxbury's (1995, Ch. 5).

Aaron Director was in the unusual position of an economist appointed to the Chicago Law School, to succeed Henry Simons, who was also an economist. At the Department of Economics at Chicago, he had a number of remarkable colleagues, amongst whom one counts Frank Knight, George Stigler and Milton Friedman. The Chicago group came to adopt a distinct approach to economic analysis, which insisted on generating testable predictions and on conducting empirical research for the purpose of such tests (Reder, 1987). 'Indeed, the defining traits of Chicago neo-classicals - the suspicion of government and the insistence that markets protect rational individual choice and self-determination - reflect a distinctively American style of individualist ideology' (Duxbury, 1995, p. 418).

Director's problem at the Law School was how to turn his lawyer colleagues round to taking economic analysis seriously. Director, a brilliant economist, applied economic insights to legal cases, in particular in antitrust law (Duxbury, 1995, pp. 343-344; Manne, 1993, p. 5 f.). Accepted wisdom at the time, stemming from the depression and the New Deal, held that in order to achieve effective competition, industry had to be closely supervised and regulated. Director showed this conclusion in most cases to be unwarranted, indeed counterproductive: monopoly was more often alleged than it was effectively present and detrimental to consumer interests. The field has continued to interest Chicagoans (Bork, 1978; Bowman, 1973; Posner, 1976). The battle about the role of antitrust law continues to this day; McChesney and Shughart II (1995) consider the debate in 1997-1998 over the pressure being put on Microsoft for its alleged monopolisation of the computer software market by tying its web browser, called Internet Explorer, with its already domineering Windows operating system. Director's efforts led, during the 1940s and 1950s, to a variety of studies of other legal subjects with clear economic connotations: corporate law, bankruptcy, securities regulation, labour law, income tax, public utility regulation and torts.

Posner and others, writing the history of law and economics at Chicago years later, designate this period as the 'old' law and economics (Posner, 1975a, p. 758; also Ackerman, 1984, p. 63; Kitch, 1983a; Mercuro and Medema, 1997, p. 193; Veljanovski, 1982, p. 7). They contrast it with the 'new' law and economics emerging in the 1960s, whose research agenda was to apply 'economics to core legal doctrines and subjects such as contract, property, tort and criminal law' (Duxbury, 1995, p. 340). About the new movement, Rowley (1989b, p. 125) observes 'its distinctive feature is the application of market economics to legal institutions, rules, and procedures which in certain areas (notably in tort and in crime) are not conventionally seen to influence market behavior, but which indeed are defined in terms of market failure'.

The contrast between the 'old' and the 'new' economics is perhaps overblown (Duxbury, 1995, pp. 340-341), but contains a grain of truth. Several events mark the overstepping of traditional boundaries of economics, characteristic of the 'new' law and economics. One influence is surely Gary Becker's initiatives to analyse non-market behaviour with economic tools: starting with his 1955 doctoral dissertation on *Discrimination in the Market Place* and broadening in his later work on the economics of crime, of the family, on human capital and alleged (ir)rational behaviour (Becker, 1957, 1962, 1975, 1976, 1981). Years later, he summarised his approach as follows: 'Indeed, I have come to the position that the economic approach is a comprehensive one that is applicable to all human behavior, be it behavior involving money prices or imputed shadow prices, repeated or infrequent decisions, large or minor decisions, emotional or mechanical ends' (Becker, 1976, p. 8).

After initial indifference, Becker's thesis came gradually to be seen as a significant contribution to economics and indeed was the justification for the Nobel prize in 1992. Posner is of the view that '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' (Posner, 1998, p. 26; quoted by Duxbury, 1995, p. 396; Posner, 1993).

During the same period - the late 1940s and the 1950s - several other studies opened up fields which later became part of law and economics. For the public choice movement one could point to Duncan Black's writings (1948a, 1948b, 1958) on committees and elections in Britain. In 1954 Scott Gordon (1954, 1958) published a study on the economics of managing a scarce resource in common property, the fisheries, from which the economics of the environment later developed. The next year, Tiebout (1956), studying competition amongst local authorities through expenditures appealing to their taxpayers, unwittingly laid the foundation for what later became the economics of federalism as a system of competition amongst governments. Downs (1957), with his economic theory of democracy, opened the field of the economics of political institutions more broadly and was followed shortly by Buchanan and Tullock's (1962) classic *Calculus of Consent*, which started the public choice school.

Duxbury (1995, pp. 379, 417) emphasises that law and economics should not be considered a direct descendant of American legal realism. While it shares with that movement the view that for a better understanding of law one must rely on the social sciences and on empirical study, practitioners of law and economics are much more precise than were the realists about where to borrow - from economics; from other social sciences to the extent that they adopt the rational choice model - and about the agenda for empirical research flowing

from that position. The canons for conducting empirical research have also been considerably refined since the time when the realists were active.

4.2 Paradigm Proposed: Economics into the Main Areas of Law (1958-1973)
A visible step in the emergence of law and economics at Chicago was the creation, in 1958, of the *Journal of Law and Economics*, with Aaron Director as its first editor. Soon afterwards, Coase moved to Chicago and became its editor. In 1960 he published his seminal article on social cost in that journal (Coase, 1960). Demsetz was amongst the earliest scholars realising the significance of the article. He underscored it in a series of perceptive articles (Demsetz, 1964, 1966, 1967, 1972a, 1972b). He first used the term 'the Coase theorem' (1972b, Pt II).

The article is usually taken to stand for the proposition that externalities are no ground for government intervention, but merely indicate that property rights are not adequately specified. When they are, and provided parties to the externality can costlessly negotiate, specification of rights is sufficient for attaining the optimal ('efficient') outcome; the particular way in which the rights are allocated between the parties is indifferent to the economic outcome. The article is also important for drawing attention to the concept of transaction costs. In Coase's examples the concept was simple enough: transaction costs encompass the cost of identifying potential contract partners, of coming to an agreement with them and of 'policing' the solution. Transaction costs prevent apparently profitable deals from being consummated. They concern both information problems and problems of 'strategic behaviour' resulting from the impossibility to fully supervise one's contract partner or from difficulties of 'collective action'. The concept has been extended to regulatory contexts and to the operation of government itself. Its meaning has thereby been singularly expanded. Precisely what is now meant by transaction costs is a matter of debate. One may expect the reduction of transaction costs to be an important concern in law and changes in legal institutions to reflect the discovery of ways to lower transaction costs.

A second seminal article was a paper by Alchian, then at the Rand Corporation in California, on the rationale for property rights, which was circulated in the late 1950s but published only several years later (Alchian, 1965). It looked at the effects of differences between private and public ownership and treated them as economic variables that could be manipulated. Calabresi, at Yale, published a third, equally fundamental, paper on tort law as a system for inducing the proper level of caution in activities liable to cause damage to other persons, considering the cost of the damage as well as the cost of administering the system (Calabresi, 1961).

These papers struck the fancy of a number of economists and became the seeds for a flurry of articles on legal subjects such as property rights, torts, contracts and procedure, for example Alchian and Demsetz (1969, 1972, 1973);

Calabresi (1965a, 1965b, 1970); Calabresi and Melamed (1972); Calabresi and Hirschoff (1972); Cheung (1968, 1969a, 1969b, 1972, 1973); Dales (1968a, 1968b); De Alessi (1969); Demsetz (1964, 1966, 1967, 1968, 1969, 1972a, 1972b); Furubotn and Pejovich (1972, 1974); Landes (1971); McKean (1970a, 1970b); Oi (1973); Pejovich (1971, 1972); Peltzman (1973); Posner (1972a, 1973a, 1973b); Stigler (1970). The *University of Chicago Law Review* published the proceedings of a symposium on product liability in its 1970 issue. Manne (1962, 1965, 1966a, 1966b, 1967) published books and papers on corporation law, controversially taking the defence of insider trading. Samuels (1965, 1973) published two extensive bibliographies of publications dealing with law and economics, broadly casting his net, but showing nonetheless how much literature had been generated in the space of a decade.

The literature in this period was mostly the work of economists. The focus on property rights earned it amongst economists the label 'property rights approach', even where it dealt with contractual practices, products liability or forms of industrial regulation. The term faded away in later years for the more encompassing one of 'economic analysis of law'.

Most contributors in the early days subscribed to the views of the Chicago school of neoclassical economics (Duxbury, 1995, p. 369; Mercuro and Medema, 1997, Ch. 2). The contributions of the 'Chicago group' altogether overshadowed those by economists of other persuasions, such as Leoni, ([1961] 1991); Samuels (1971, 1972); Schmid (1965) or Stewart Macaulay, a lawyer-sociologist, who published a remarkable study on informal contractual relations, which has since become a classic (Macaulay, 1963). The success of the Chicago approach persisted in later periods. Hayek's *Law, Legislation and Liberty* (1973, 1976, 1979) for instance, published contemporaneously with Posner's textbook on law and economics (Posner, 1972b, 1977), went essentially unnoticed at the time amongst the law and economics community, even though Hayek received the Nobel prize for economics in 1974. In retrospect this may seem a regrettable example of tunnel vision; looked at in the perspective of the time, it testifies to the intense enthusiasm generated by the research agenda the Chicago School proposed and to the dynamism and persuasiveness of its proponents.

A few contributors in this early period were lawyers. The names of Calabresi and Manne come to mind. Participation of lawyers is essential since, as we saw above, convincing lawyers turned out to be the critical point in the evolution of the first wave of law and economics, a century earlier. Calabresi played a key role here: 'The distinctive quality of Calabresi's work was to show the power of simple economic principles to rationalise a whole body of law, and to develop a coherent basis for its reform' (Veljanovski, 1990, p. 21). Manne contributed in a different way by organising, from 1971 on, short intensive training seminars in economics for lawyers and judges, and in law for economists (Manne, 1993, p. 10; Duxbury, 1995, p. 359).

4.3 Paradigm Accepted: law and economics into the Law Schools (1973-1980)
Three events signal a change in the movement in the direction of capturing the hearts and imagination of lawyers: the foundation, in 1972, of the *Journal of Legal Studies*; the first publication, of Posner's (1972b; second edition 1977) introduction to the economic analysis of law, both at the Law School of the University of Chicago; the organisation, from 1971 on, of Henry Manne's already mentioned Economics Institutes for Law Professors, short intensive seminars in economics for lawyers, be they judges, practitioners or law teachers (Manne, 1993, p. 10). Together, one might say, they mark the entrance of law and economics into law schools in the United States.

Posner's book was written by a lawyer for lawyers in a clear and straightforward style. It steered clear of economic jargon and adopted the lawyer's well-known distinctions amongst fields of law. It analysed well-known legal doctrines across the entire spectrum of the law. 'Posner's *Economic Analysis of Law*, which first appeared in 1973, sounded most explicitly the modern theme of economic imperialism: You name the legal field, and I will show you how a few fundamental principles of price theory dictate its implicit economic structure' (Epstein, 1997, p. 1168). While these features no doubt contributed to its success, the decisive factor may well have lain in the substance of the book: the efficiency thesis of the common law.

In earlier contributions, law and economics scholars had shown that different institutions - property rights, contractual arrangements, liability rules - could be looked at as in some sense the best option, that is the efficient solution in neo-classical economic terminology. Private property rights generally create better incentives for husbanding scarce resources than do common property or freely available objects. Owners of orchards might be thought to profit freely from the activity of bees pollinating their trees, an externality which some used as a textbook example to show the need for government regulation; closer study showed, however, a practice of contracts between bee keepers and tree owners, making it profitable for both to place beehives near the orchard as needed (Cheung, 1973). Liability rules in tort could be shown not merely to redress the balance disturbed by the tort, but also to create the proper incentives for those whose activity might cause damage to others, to observe care to the extent that its cost is lower than that of the damage thereby prevented (Posner, 1972a).

Posner generalised this idea across the spectrum of the law. Already in the first edition of his book, he put forth the thesis that all rules of the traditional common law reflected such an efficiency logic and that, as a matter of normative judgement, it was desirable that they do so: pursuit of efficiency, here as elsewhere, aims at avoiding waste or maximising the wealth of society. The thesis yields an alluring research agenda: to tease out, using concepts borrowed from neoclassical economics, what would be the 'efficient' rules throughout the domains of the traditional common law and to determine

whether the common law in fact conforms to this logic. The research programme was attractive to lawyers because the neoclassical machinery as it was presented in Posner's book looked easy enough to learn and to apply to legal problems.

It is essentially this research programme which has occupied the law and economics community through the 1970s, it is difficult to say whether it is the descriptive or the normative component which provided the greater attraction. Posner himself has been amongst the most ardent defenders of his own thesis. He maintains it, in only slightly weakened form, in the fourth edition of his book, in 1992, presenting the common law as a system of rules 'for inducing people to behave efficiently, not only in explicit markets but across the whole range of social interactions. In settings in which the cost of voluntary transactions is low, common law doctrines create incentives for people to channel their transactions through the market. ... In settings where the cost of allocating resources by voluntary transactions is prohibitively high, making the market an infeasible method of allocating resources, the common law prices behavior in such a way as to mimic the market.' (Posner, 1992a, p. 252; quoted by Duxbury, 1995, pp. 410-411).

4.4 Paradigm Questioned (1976-1983)

Already during the 1970s, the Chicago approach to law and economics was criticised, in particular by the institutionalists (Goldberg, 1976a; Liebhafsky 1976; Samuels, 1976a; Schmid, 1976). Schmid (1976), for instance, made the important point that, since for any distribution of property rights there is a cost-minimising allocation of resources, cost minimisation itself - and by extension the efficiency logic - cannot provide the foundation for the way in which property rights are distributed. Indeed, the allocation of property rights determines what is a cost of what, a conclusion which implicitly follows from the Coase theorem.

These early criticisms went largely unnoticed. The critics made more inroads at the end of the decade, when several symposia were held to examine what law and economics had to contribute to the theory of law (Rizzo, 1980a; Hofstra Symposium 1980; Posner, 1981a; Pennock and Chapman, 1982; Cramton, 1983). The debates brought together the best American minds supporting law and economics and those critical of it. Posner defended law and economics against attacks from legal philosophers such as Dworkin and Fried and critical legal studies thinkers such as Horwitz and Kennedy, and friendlier criticism from lawyers in the Yale tradition such as Calabresi and Kronman and Austrian economists such as Rizzo.

The debates brought out weaknesses of the efficiency thesis as Posner has proposed it (Duxbury, 1995, p. 391; Veljanovski, 1980, pp. 182-187). The first is the point, already mentioned, that efficiency cannot be the foundation of the distribution of property rights, since for any distribution, an efficient allocation

of resources can be found. Hence the efficiency thesis is circular. It may be called the circularity thesis and is underscored by several writers besides Schmid (1976) already mentioned: (Baker, 1980; Hart, 1977; Michelman, 1980, p. 448; Samuels and Mercuro 1984, p. 112).

A second difficulty is that the efficiency thesis appears to be non-falsifiable. Where an apparently inefficient arrangement is found, hitherto unnoticed costs can be called in to account for it. This may be useful as a heuristic, but as a way of theory testing, it does not pass muster. To test a theory and expose it to the risk of refutation, one must delimit the set of costs which will be taken into consideration.

A third question pertains to the ahistorical character of the efficiency thesis. (Veljanovski, 1982, p. 97). The thesis suggests that for any given problem there is one efficient solution. Once discovered, there is no reason to move away from it. Yet law tends to evolve over time; a solution considered satisfactory yesterday may no longer seem so today. What explains the change? And what explains that in full knowledge of 'efficient' solutions, we move away from them, as we do in various forms of regulation, such as rent control, minimum wages or environmental regulation? Along similar lines, in the light of the efficiency thesis, persistent differences amongst modern legal systems are puzzling: if there is a tendency towards efficiency and the efficient solution to any legal problem is unique, legal systems should converge. Law and economics needs to address such questions.

A fourth question, raised in particular by Austrian economists, concerns the subjectivity of values. To determine 'efficient' solutions as Posner envisages them requires that the gains resulting from a change of rule are weighed against the losses, in order to choose the rule which promises the optimal result. On what scale are gains and losses occurring to different people to be weighed? Where people transact, their transaction makes such gains and losses comparable, putting them, as it were, for an instant on a single scale which we can observe. In practice, gainers and losers from a particular project do not necessarily transact and compensation of losers by gainers, leading to a Pareto improvement, rarely take place. To arrive nonetheless at policy conclusions, Posner must resort to the Kaldor-Hicks criterion, whereby a rule change is considered an improvement if the gains it procures would be sufficient to offset the losses, both being measured by real or presumed willingness to pay.

Such interpersonal comparisons of value take place all the time in the practice of the law. The judge must put a figure on the losses suffered by a tort victim. If tort rules must serve to induce potential tortfeasors to take proper care, accident costs falling on the side of the victim must be compared to prevention costs falling on the side of the tortfeasor. Common sense accomplishes such comparisons in practice, but, critics argue, they are suspect nonetheless in a scientific sense. This makes problematic, for instance, the

policy recommendations Posner derives from the Hand-test in tort law as maximising welfare (Rizzo, 1980b). The criticism has later been amplified by Trebilcock (1987, 1989). Incentive logic and risk-spreading logic do not lead to unambiguous policy conclusions for welfare maximisation: 'Indeed, why not allow the victim to sue *anyone* who ostensibly is a superior risk-bearer to him or to the chairmaker, for example, the latter's banker, law firm, accounting firm, securities underwriter, timber supplier, trucking operator, or indeed a large, well-endowed, well-insured, or well-diversified enterprise totally unconnected to either party? At the limit, it is not clear why, if the courts are committed to spreading accident costs as thinly as possible, there is any logical stopping point short of rendering the state liable for all accident costs ...' (Trebilcock, 1987, pp. 955-956). And he adds a little further down: 'This might be taken to mean, in economic terms, that in cases like the above, accident costs should be internalized to the activity whose level or supply is likely to be most responsive to cost increases (price elastic). While perhaps correct in theory, this criterion seems hopelessly non-operational in all but the most extreme examples' (p. 988).

A fifth question deals with the origin of the perceived efficiency logic. If the common law reflects an efficiency logic, as Posner submits it does, it ought to be possible to formulate a theory accounting for the emergence of that logic. Various attempts have been made to articulate such a theory (Cooter and Kornhauser, 1980; Goodman, 1978; Hirshleifer, 1982; Hollander and Mackaay, 1982; Landes and Posner, 1976, 1979, 1980; Priest, 1977, 1980; Priest and Klein, 1984; Reese, 1989; Rizzo, 1980d; Rubin, 1977, 1982; Terrebonne, 1981). None so far has found general acceptance. It is submitted that the judges operating during the formative years of the common law doctrines a century ago were imbued with laissez faire values congenial to 'efficient' legal rules (Posner, 1992a, p. 255), or that given the constraints in judicial procedure under which judges operate, they are not, unlike Parliament, at liberty to pursue redistributive policies, nor are they subject to intense interest group pressure (Posner, 1992a, p. 524). Yet the judicial policies pursued by modern courts in deciding on the scope to be given to human rights proclaimed in constitutions clearly has distributive effects and their 'efficiency' in Posner's sense would not be easy to demonstrate. Consider also Jules Coleman's observation that what parties demand of the courts is not 'the imposition of an efficient rule, but ... the imposition of any rule that will reduce uncertainty. For such a rule facilitates rational contracting, the long term consequences of which will be efficient' (Coleman (Jules), 1989, p. 190). On this question it is well to remember Sir Arthur Eddington's admonition that '[i]t is also a good rule not to put overmuch confidence in the observational results that are put forward until they are confirmed by theory' (Anonymous, 1978, p. 132).

A final point concerns distributive questions. Even if one grants that the core common law rules reflect an 'efficiency' logic, much modern legislation

has an obvious redistributive purpose, and indeed citizens usually seek redistribution through policies they demand from their elected representatives. How this process operates and what its limits are ought to be part of the research agenda of law and economics.

4.5 The Movement Shaken (From 1983 Onwards)

The debates, with their ferocious attacks from all quarters on law and economics, might seem to have left Chicago style law and economics in tatters. But they did not. On the contrary, Posner continues to publish books (Posner, 1981b, 1988a, 1990a, 1990b, 1992a, 1992b, 1992c, 1995a, 1996a, 1996b, 1998; Posner and Silbaugh 1996; Posner and Parisi, 1997). His textbook is currently in its fifth edition (1998). Its closest competitor, by Cooter and Ulen (1996), is in its second edition. The *Journal of Law and Economics* and the *Journal of Legal Studies* continue to flourish. A series of annual research reports, *The Research in Law and Economics* (Carroll, 1979), started in 1979, continues to this day. The main early proponents of law and economics, Bork, Breyer, Calabresi, Easterbrook, Posner and Scalia - some no longer recognising an allegiance to the movement - have been elevated to the bench. About Posner himself, Duxbury muses: 'As he continues to develop and promote his faith in the principle of wealth-maximization, those who stand resolutely opposed to that principle continue, with equal vigour, to demonize him' (Duxbury, 1995, p. 416). For law and economics as a whole, the 1980s have been described as a period of maturation and consolidation in the USA (Veljanovski, 1990, p. 26).

Yet something has changed. The confidence with which the Chicago research agenda for law and economics was taken for granted as the only game in town appears shaken. The debates have allowed viewpoints dissonant from strict neoclassical economics to come out of the shadows. Recent overviews (Mercuro and Medema, 1997; Teijl and Holzhauer, 1990) deal with Chicago Law and Economics, Public Choice Theory, Institutional Law and Economics and Neo-institutional Law and Economics, as well as Austrian Law and Economics.

In 1981, a new journal, the *International Review of Law and Economics*, was created at the initiative of Ogus and Rowley, then at Newcastle-upon-Tyne. Four years later, in 1985, yet another periodical saw the light, at Yale University, the *Journal of Law, Economics, and Organization*. In their opening statement, the editors observe that law and economics 'has expanded ... to take account of the institutional forms within which legal rules and transactions take place' (Leo, 1985, p. 4). In recent issues, this focus is maintained, since the editors 'hold the study of institutions - especially economic, legal and political institutions - to be specifically important and greatly in need of careful analytic study.' (Leo 1997, p. 0)

5. Trends and Themes

Can one discern a pattern amongst the many viewpoints now represented within law and economics broadly written? I venture to list a few common themes, most of them proposed as enrichments of the Chicago law and economics research agenda, rather than as alternatives to it: the role of institutions; historical studies; strategic behaviour in human interaction; limited rationality of human actors; uncertainty and entrepreneurship; the contributions of public choice and game theory; the relationship between the law and economics and the sociology of law.

In considering these possible enrichments, it is well to keep in mind the causes of the decline of the first wave of law and economics. They justify Posner's admonition that 'too many bells and whistles will stop the analytic engine in its tracks. ... A commitment to a relatively simple economic model, one that does not supply a facile explanation for every regularity (or peculiarity) in human behavior, forces the analyst to think hard before discarding the possibility that the behavior under scrutiny may indeed be rational in a straightforward sense. By the same token, a too-great readiness to abandon the simple model in favor of alternative approaches to behavior at the first sign of difficulty carries the risk of overlooking promising avenues for economic analysis' (Posner, 1989, pp. 60, 62). But against it Backhaus and Stephen (1994, pp. 6-7) argue, presenting the new *European Journal of Law and Economics* in 1994, that 'considerable disappointment with the lack of usefulness for practical economic policy of much rigorous theoretical work in economics has resulted in a resurgence of institutionally rich economic work'.

5.1 Institutions

The important role of institutions has been stressed in many corners: the older institutionalists such as Samuels (1971, 1972, 1974, 1975, 1976b), Samuels and Schmid (1981) and Schmid (1965, 1976, 1978); and the newer ones such as Williamson (1985, 1986, 1996), Eggertsson (1990, 1993, 1996), Alston, Eggertsson and North (1996) and Komesar (1997), the economic historians (Bouckaert, 1996, 1997; Libecap, 1986, 1989, 1992, 1993a, 1993b; Milgrom, North and Weingast, 1997; North, 1984, 1986, 1991, 1993, 1994, 1995; North and Wallis, 1994; North and Weingast, 1996; Weingast, 1993, 1995), the management literature (Knight, 1992; Knight and Sened, 1995; Miller, 1992; Gomez, 1996), Austrian economists linking to Carl Menger's contributions (Langlois, 1986, p. 247; Rizzo, 1985), political scientists (Elster, 1989, p. 147).

Coase himself, whose 1937 article on the firm may be considered the first contribution in modern law and economics insisting on the role of institutions, has explicitly sided with these concerns (1937, 1992, 1993): 'It makes little sense for economists to discuss the process of exchange without specifying the

institutional setting within which the trading takes place since this affects the incentives to produce and the costs of transacting. I think this is now beginning to be recognised and has been made crystal clear by what is going on in Eastern Europe today.' (Coase, 1994, p. 12). Indeed one may consider that all of law and economics, in as much as it seeks to elucidate the rationale of existing legal rules, engages in institutional analysis.

To understand what an institution is, start with the neoclassical model. The model supposes that agents are informed about potential trades, that profitable agreements are reached without delay or posturing and that deals are faithfully performed. These are, to be sure, simplifying assumptions to make the model manageable. They allow one to construct arguments about how social optimal arrangements (efficiency) come about.

In this model there is no need for the fixity that institutions provide. 'Because most of the formal economic models of competition, exchange, and equilibrium have ignored ignorance and lack of costless full and perfect information, many institutions of our economic system, institutions that are productive in creating knowledge more cheaply than otherwise have been erroneously treated as parasitic appendages. The explanation of use of money, expertise with dealing in a good as a middleman specialist with a trademark or brand name, reputability or goodwill, along with advertising of one's wares (and even unemployment) is often misunderstood. All these can be derived from the same information cost factors that give rise to use of an intermediary medium of exchange' (Alchian, 1977, p. 123). 'If human beings were omniscient, most markets would make no sense. After all, there's no reason to trade stocks if everyone knows the true value of every company. But people are not omniscient. And markets are the best way yet devised to overcome human limitations in deciding what to build, buy, or sell' (Browning and Reiss, 1998, p. 100).

Institutions answer the observation that in reality, situations are often too complicated for ordinary economic actors to find the theoretically optimal arrangement and are simplified to be manageable. 'When it is costly to transact, then institutions matter. And it is costly to transact. ... Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics' (North, 1996, p. 344). Institutions simplify the decision problem for economic actors, by imposing restraints on each person's conduct which render it substantially predictable to others. 'Institutions are, in an important sense, congealed social knowledge. By following institutionally-sanctioned patterns of behavior, separate individuals are able to coordinate more completely their actions and plans. This is because institutions often limit the options available to an individual thereby reducing

the uncertainty about what others are going to do' (O'Driscoll Jr and Rizzo, 1996, p. xxii).

Institutions are rules in a broad sense. Heiner (1983) has attempted to formalise the reasons for using rules, both heuristic rules in individual decision making and social rules in human interactions. Their virtue lies in the relative fixity they provide. But the fixity is also their weakness. At the time of its creation, an institution may be chosen so as to provide generally the best trade-off in the face of the circumstances of the moment. As circumstances change, institutions may come to represent less than optimal trade-offs and yet their fixity prevents them from being instantly adjusted. The benefit of fixity and predictability is bought at the risk of ill fit over time.

Institutions constitute an enrichment of the law and economics agenda. The research programme they imply is not radically incompatible with the 'optimisation' ('efficiency') idea inherent in the neo classical agenda. But rather than assuming immediate optimisation to be the goal of all decisions within the economic system, an institutional agenda would admit institutions as constraints on optimisation and would consider change of institutions an independent goal. 'The general effort to take account of information asymmetry and other transaction costs, while preserving the assumption that individuals maximize utility, is coming to be called 'neoinstitutional economics' ' (Riker and Weimer, 1993, p. 84)

5.2 History

The institutional agenda sketched above quite logically leads to an increased interest in historical studies: institutions provide fixity in the short run and evolve in the longer run. They leave a trace which we can study. Change of institutions points to a change in the relevant transaction costs visible to interested parties. North (1981, 1986, 1989, 1994, 1995) has explicitly drawn attention to the connection between institutions and history.

Historical studies give an empirical dimension to law and economics work, which may have been lacking in earlier law and economics work, which focused on the function of different legal rules. Law and economics has been too theoretical, says Becker (Roundtable, 1997, p. 1137). To this Epstein (1997, p. 1173) adds that the easy conquests of theory and practice have already been made. ... But precisely because knowledge is so great, the law of diminishing returns explains why new advances are so hard to come by. For Epstein, 'the greatest hope for advancement, barring any major unforeseen conceptual breakthrough, is from more attentive study to the evolution - be it by growth or decline, or both - of particular institutions and social arrangements' (Epstein, 1997, p. 1174)

Quite a few historical studies in law and economics have appeared over the past few years, such as Aftalion (1987, 1990); Alston, Eggertsson and North

(1996); Baechler (1995a, 1995b); Bailey (1992); Beito (1990); Bouckaert (1996, 1997); Ekelund, Hébert and Tollison (1989); Epstein (1994); Green and Shapiro (1994); Greif (1989, 1993, 1997); Greif, Milgrom and Weingast (1994); Hovenkamp (1983); Libecap (1986, 1993b); Mackaay (1997); Milgrom, North and Weingast (1997); North and Weingast (1996); Roe (1994); Rosenberg and Birdzell Jr (1986); Rosenthal (1992); Secretan (1990); Simpson (1975, 1979, 1985, 1988); Umbeck (1977a, 1977b, 1981a, 1981b); Webber and Wildavsky (1986); Weingast (1993, 1995).

5.3 Comparative Law

The reasons for engaging in more comparative work are similar to those for doing historical work. If the economic theory of law is solid, it ought to hold up when applied to the law of different countries, as much as to the law of different epochs. Mattei (1997, pp. ix, 69) complains about 'severe American-centric provincialism' of the law and economics literature and observes poignantly that 'American law and economics has been remarkably parochial, unable to question the presumed need and immutability of a legal process patterned after the American one. ... In the legal context, the mistake is that of accepting the American legal process as an undisputed background and building up models and/or generalizing observations about the efficiency of the law without considering the contingency and relativity of such background. In Europe, the same lack of comparative understanding has prevented committed law and economics scholars from developing original insights capable of shedding new light on the civilian legal process' (ibid., p. 69). Duxbury (1995, p. 409) echoes this concern in observing that 'by and large, however, modern law and economics remains rooted in the common law tradition'. Coase (Roundtable, 1997, p. 1163), in a slightly different context, has also called for more comparative work.

The *International Review of Law and Economics* regularly gives space to comparative studies (Cooter and Gordley, 1991; Mattei and Pardolesi, 1991) and surveys of law and economics in civil law countries. Levmore (1986, 1987) has published detailed comparative studies of particular institutions. Mattei (1994a, 1994b, 1994c, 1995, 1996) and Ajani and Mattei (1995) have focused on the broader aspects of the comparative approach. Scully (1987) purports to develop a general argument that civilian countries, being generally more positivist than those in the common law tradition, offer their citizens less freedom than the latter.

Scully's conclusion points to the question of the reception of law and economics outside of the United States. From the mid 1970s, it reached other English speaking countries and Sweden (Attiyah, 1970; Skogh, 1978; Harris, Ogus and Phillips, 1979; Ogus, 1980; Veljanovski, 1980, 1981, 1982; Burrows 1980; Burrows and Veljanovski, 1981; Ogus and Veljanovski, 1984). By the

end of the decade, it had found its way to the German speaking (Horn 1976; Assmann, Kirchner and Schanze, 1978; Opp, 1979; Lehmann, 1983; Schüller, 1983; Behrens, 1984) and the Benelux countries (Mackaay, 1980, 1982; Bouckaert, 1984). Mattei and Pardolesi (1991) mention interest for law and economics comparative law scholars in Italy already in the early 1960s, but without much practical echo until decades later. France has lagged behind, because, most unfortunately, an early contribution to law and economics (Rosa and Aftalion, 1977) became labelled as right-wing ideology without proper claim to scientific status (Andreff et al. 1982; Mackaay 1987). Peculiarities of the French higher education system with its centralised administration and control of appointment and promotion of law professors, providing little incentive for the reception of intellectual ideas originating outside France, may have reinforced this unfortunate development. Remarkable law and economics publications such as Lepage (1985) and Lemennicier (1988) have been by and large ignored by the legal community.

The reception in these countries appears to follow a common pattern. An early sparkling publication triggers broader interest amongst legal scholars. In England (Attiyah, 1970) 'introduced the British reader to Calabresi's economics, igniting interest among lawyers in the reform of the tort system and the efficiency of accident compensation schemes' (Veljanovski, 1990, p. 25). In Germany, this role was played by a small book of readings produced by three young scholars, who spent a year in the US (Assmann, Kirchner and Schanze, 1978). Perhaps reception in Germany was helped by the earlier Ordo-liberal or Freiburg school of law and economics, founded in the 1930s and influential after the Second World War, which included well-known scholars and politicians such as Walter Eucken, Wilhelm Roepke, Ludwig Erhard, Franz Böhm (Backhaus, 1996; Behrens, 1984, p. 8 f., 1993; Grossekettler, 1996; Lenel, 1996; Streit, 1992; Vanberg, 1998b).

Consolidation takes place as law and economics is taught in the law schools (and not only in the economics departments) and young scholars choose a law and economics subject for their thesis. The Erasmus exchange programme in law and economics has probably exerted a positive influence in Europe. So have the European Law and Economics Association and, in its sphere, the Canadian Law and Economics Association.

One must wonder whether law and economics generates outside the United States as much interest as it had earlier on and continues to do in the US. In 1991, Kirchner answered this question in the negative for Germany, in spite of the substantial literature in German on the subject. Looking to the future, Cooter and Gordley (1991, p. 262) conclude that '[b]oth Kirchner and Mattei, however, see the economic approach to law as the opponent of what remains of nineteenth-century formalism. For the economic approach to be successful, then, it must convince its critics that it can avoid the evils of formalism without

causing new evils of its own. Its success, then, may require not only openness by traditional legal scholars to a new method, but also creative adaptation of that method by its practitioners'.

5.4 Strategic Behaviour

Williamson (1985, 1986, 1996) in particular has drawn attention to the question of strategic behaviour. The neoclassical model assumes such conduct to be absent. Yet the rules for decision making within corporations or associations of condominium owners or the rules for dealing with conflicts between owners of neighbouring properties are explicable in an economic analysis of law as means to foreclose, or at least reduce, strategic behaviour in these settings of bilateral monopoly. Coleman observes that 'all rules attempt to correct some form of perceived market failing' (Coleman (Jules), 1989, p. 182). Strategic behaviour may be considered a form of market failing and it is a fruitful heuristic for lawyer-economists to consider the threat of such behaviour as the explanation for observed legal institutions. This is a refinement of the institutional agenda (see also Katz, 1998).

5.5 Limited Rationality

Psychologists observe that human reasoning does not in fact conform to the postulates of rational choice in a number of ways (Booth, Booth and Meadwell, 1993; Cook and Levi, 1990; Elster, 1986; Green and Shapiro, 1994; Hahn and Hollis, 1979; Hargreaves Heap, Hollis et al., 1992; Hogarth and Reder, 1986; Hollis, 1987; Hollis and Nell, 1975; Kahneman, Slovic and Tversky, 1982; Mackaay, 1982, Ch. 6; March, 1986; Simon, 1959, 1972, 1979, 1986a, 1986b; Tversky and Kahneman, 1974, 1986a,, 1986b; Tversky, Slovic and Kahneman, 1990). We do not, for instance, intuitively draw the proper statistical inference from a series of occurrences of some event, but attach undue weight to the more recent ones; we ask more for something we sell than we would be willing to pay to acquire it (Kahneman, Knetsch and Thaler, 1991; Knetsch and Sinden, 1984a, 1984b; Knetsch, 1989). Should these observations lead one to reject the rational choice model? That conclusion is generally considered premature. In part this is because market forces induce rationality by penalising random or otherwise irrational choices (Becker, 1962). Until we know how to formalise the bounds on our rationality, Posner's admonition about too many bells and whistles seems apposite.

5.6 Uncertainty, Discovery and Entrepreneurship

Uncertainty, discovery and entrepreneurship are at the heart of the Austrian economics research agenda. They lead to a view of competition law which is distinctly different from that derived from the equilibrium model at the centre of neoclassical economics. The equilibrium model translates a situation in

which all knowledge and know-how is presumed given and all potential transactions are presumed to have been considered. For the Austrians, all this knowledge is not given, but must be discovered. The essence of the economic problem is the discovery of new products, services and ways of doing things. The Austrians are concerned to determine the conditions required for that discovery process. This has consequences for the scope of competition law.

The advantage secured by a superior product may initially give a firm something of practical monopoly in its market. In the Austrian view, this is no cause for intervention. So long as the monopoly is contestable, in the sense that no legal impediment stops a newcomer from offering a new product which consumers accept as a substitute for the supposedly monopolistic product, the very success of the apparent monopoly is the carrot which draws competition and drives innovation. Austrians see competition as a discovery process and, one may add, the reverse as well: discovery will most readily take place through competition.

Development of a 'niche' through an innovation and subsequent imitation and dissipation of the 'niche' and search for new ones is the essence of the competitive discovery process. Breaking up such 'monopolies' because of excessive market share would, on an Austrian analysis, have the effect of stifling innovation. The literature on competition law, at least in the United States, is coming round to this dynamic view of competition and innovation, giving credence to the Austrian ideas (Barnett, 1992; Kirzner, 1973, 1979, 1985, 1997; McChesney and Shughart II, 1985; Nelson and Winter, 1982; Schmidtchen, 1993).

The Austrian views differ from the neoclassical synthesis in other important respects as well. Hayek has insisted on the subjective nature of information economic actors use in making their plans and reaching their decisions (Hayek, 1948; Kirzner, 1984; O'Driscoll Jr and Rizzo, 1996; Barnett, 1998). Information about production and consumption plans is revealed and continuously updated through the price mechanism. One cannot correctly gauge this information outside the transactions in which it is revealed through the market. This is no less true for the judges in our system, than it was, fatally, for government officials running the former socialist republics. Austrians generally take a dim view of judicial 're-engineering' of contracts.

How much Austrian and Chicago neoclassical economics actually differ is a matter of debate. Paqué (1985) submits that the distance is smaller than it appears to be. Boettke (1997) sees neoclassical economics as the product of a set of simplifying assumptions about innovation and competition introduced in classical political economy, which made possible the rapid mathematisation of the discipline, but entailed a lack of realism which, in his view, is fatal. Austrian economics has, in his eyes and those of Behrens (1984, p. 22), remained faithful to the older but richer tradition of political economy.

The consequences of the Austrian views for law and economics differ significantly from those reached in a neoclassical perspective (Rizzo, 1980c, 1985; Bouckaert, 1984; Teijl and Holzhauer, 1997). For instance, comparisons of prevention costs for tortfeasors with accident costs for victims, as the Hand test for negligence law would require, are without a foundation on an Austrian view, which for that reason tends to favour strict liability or no liability. The implications of Austrian views for civil law have been explored in some detail and compared to those of Chicago neoclassical views in a recent doctoral thesis in Rotterdam (Teijl and Holzhauer, 1997).

5.7 Public Choice

Public choice is the application of the rational choice model to political phenomena, the field of political science and of public law. It is, to put it another way, a general theory of 'how private interests operate in the public domain' (Ogus, 1994, p. 58). Its core ideas can be traced back at least to Machiavelli. For the current movement the immediate beginnings are works by Duncan Black in the UK and Anthony Downs in the USA (Black, 1948a, 1948b, 1958; Downs, 1957). They were followed by seminal contributions dealing with collective decision making through Parliament, with bureaucracy and with the problems of collective decision making (Buchanan and Tullock, 1962; Olson, 1965; Niskanen, 1971, 1994). There is now a substantial literature on public choice. Readable surveys for lawyers are De Clerq and Naert (1985); Farber and Frickey (1991); Mercuro and Medema (1997, pp. 84-100); Mitchell and Simmons (1994); Stearns (1997); Wagner (1990). Other important surveys can be found in Mueller (1979, 1989, 1997).

Implicit in the neoclassical model underlying mainstream law and economics is the view that government's role is to correct market failure. It is consonant with the broadly held public interest view of government: the government acts as the impartial umpire of social relationships, stepping into the fray to correct whatever has gone astray in the workings of market and other social forces.

Public choice casts doubts on this view. Its proponents question the underlying assumption that actors presumed selfish in private dealings would behave selflessly upon assuming public office. Public choice proposes a private interest view of politics, a world in which actors in political roles act to maximise something of direct interest to them, but defined in ways particular to their roles: politicians are assumed to maximise their chances of re-election; bureaucrats, the size and mandate of their bureaux (Niskanen, 1971; Dunleavy, 1991); voters, the benefits they draw from government programmes and interest groups, the programmes conferring benefits upon their members.

A startling conclusion of public choice is the thesis of the rational ignorance of voters. Since voters cannot expect their individual vote to make a difference between one political programme and another, they have no interest in

informing themselves properly on the differences between the two. Political discourse directed at such voters deals in general slogans and in the image of politicians. By contrast, where opposing politicians in an election are divided on a programme which directly affects a particular group of voters, such as farmers, these voters very much have an interest in informing themselves on where the politicians stand on that issue and in promising their vote to those who will benefit them most. Lobby groups channel this interest for their constituents. Olson (1965) has shown that the difficulties of organising lobby groups vary directly with the size and cohesion of the constituent group. Compact groups, as a consequence, are expected to have a disproportionate influence on politicians. Public choice predicts that politicians will generally want to adopt programmes whose benefits are visible and fall upon concentrated groups, while their cost is dispersed as widely and imperceptibly as possible. The actions by interest groups designed to get their members benefits not available in the market have since become known as rent-seeking (Buchanan, Tollison and Tullock, 1980; Krueger, 1974; McChesney, 1997; Posner, 1975b; Rowley, 1988; Rowley et al., 1988a, 1988b; Tollison, 1982, 1987, 1997; Tullock, 1987, 1989, 1993). There is a lively literature on the economics of federations (Breton, 1987, 1989, 1996; Breton and Scott, 1978, 1980; Hamilton, 1987; Kendall and Louw, 1989; Migué, 1993, 1997; Tiebout, 1956; Weingast, 1993, 1995).

5.8 Economic Regulation

Public choice enriches the economic analysis of law in that it provides an understanding of the forces controlling redistribution and of 'economic regulation'. Economic regulation denotes legal restraints upon market actors' behaviour, elaborated by legislators, courts or administrative agencies (Ogus, 1994, p. 1; Hägg, 1997, p. 337). Examples are regulation of state-run utility companies, regulation of transportation, airlines, telecommunications industries, environmental protection, safety and drug regulation, consumer protection, but also 'price-fixing, taxes, subsidies, tariffs, quotas, merger control' (Hägg, 1997, p. 339). All these forms of regulation were seen until the 1960s as attempts to correct market failings, the main justification of government in the neoclassical model.

The question is whether economic regulation in fact improves overall welfare. Within law and economics the answer came increasingly to be seen as negative, in particular with respect to what was until then considered to be the most telling case for government intervention: natural monopoly (Priest, 1993, p. 292). Regulated monopolies were shown often to 'capture' the regulatory agency supervising them, to the detriment of the public, which faced higher than necessary prices. The empirical and theoretical research of these issues centred around the *Journal of Law and Economics.* Coase's article on social cost may be read in this light: the thesis that any form of externality calls for

government correction (through liability or taxes) was shown to be mistaken; externalities correct themselves if property rights are properly specified and provided no significant transaction costs stand in the way of negotiations between parties to the externality. Coase (1974) showed, similarly, that lighthouses, thought to be the public good *par excellence*, were in fact for a long time privately run in the UK. Cheung (1973) found that pollination by bees, presumed to be a positive externality and hence source of market failure, was in fact the object of a lively market between beekeepers and farmers.

Burton argues more generally that 'uncontracted or external effects are a pervasive phenomenon of social life' (Burton, 1980, p. 56) and cannot by themselves be sufficient reason for government intervention. What counts as an actionable externality depends on how the boundaries of property rights are defined in a society. There is a lively literature tending to show that the presumed market imperfections are not in fact fatal to the market process or otherwise are circumvented by the ingenuity of market participants (Cowen, 1988). Deregulation of transportation, communication, energy and financial industries in the United States and privatisation of public enterprise from the late 1970s onwards has generally brought benefits to consumers in the form of lower prices and wider diversity of products, lending credence to the 'private interest' view of regulation and casting doubts on the beneficence of government intervention.

If government interventions are not *ipso facto* beneficent, we need a theory to explain how they come about and which are beneficent, which are not. Initially this theory was articulated by Stigler (1971); Posner (1971, 1974) and Peltzman (1976, 1989) at Chicago in terms of interests groups getting their way with politicians. Their approach was consonant with the teachings of the public choice school (Priest, 1993, p. 293). The upshot of this view was that under no circumstances could economic regulation be viewed as beneficent.

From the 1980s onwards, this altogether pessimistic view came to be questioned. Becker showed in two articles that the privileges sought by interest groups would trigger their own counterweight for other interest groups and concluded that the only enduring forms of regulation would benefit all actors at large, rather than specific groups. (Becker, 1983, 1985).

The prevailing view now appears to be that regulation need not always be detrimental to the public interest. Defining and enforcing property rights and contracts and developing tort liability rules sustain the market, rather than hamper it. They are law just as much as the economic regulation of the kind discussed above. Ogus (1994, p. 75) sums up the debate thus: 'public choice theory, and its various offshoots, rightly focus our attention on the way in which regulation affects a variety of private interests. The distributional impact of interventionist measures may be concealed behind the public interest rhetoric

which usually accompanies them, but it remains crucial to normative evaluation' (see also Hägg, 1997, p. 356-357).

5.9 Game Theory

Game theory is a mathematical tool for studying interactions amongst people, in which one person's choice depends on what others choose and vice versa. It has been used in economics and in moral philosophy for quite some time, but has been introduced in legal analysis only recently (Barnett, 1989, p. 9). One use is to detect recurrent patterns in human interaction, leading humans to adopt norms which are models for property rights and contracts. Game theory then provides an understanding of spontaneous order (Axelrod, 1984; Benson, 1994; Birmingham, 1968; Mackaay 1988b, 1991; Parisi, 1995; Picker, 1997; Sugden, 1986, 1989; Ullmann-Margalit, 1977, 1978). Game theory has also been used to shed light on bargaining situations. A helpful overview of the uses of game theory in law is given in (Baird, Gertner and Picker, 1994). There is an ample literature on what game theory can teach with respect to the social contract and the foundation of the state, but this lies outside of law and economics proper (Kerkmeester 1989; Voigt, 1996, 1997).

5.10 Links with the Sociology of Law

In recent years, several authors have called for closer links between law and economics, and the sociology of law. Ellickson for one, in several writings (Ellickson, 1987, 1989, 1990, 1991), with a comment by Posner (1989), pleads for overture to various forms of 'human frailty', a sensibility readily attributed to sociologists, whom he criticises, however, for engaging in much observational work without a proper theory to guide those observations. Others have called for this rapprochement as well: Bouckaert (1994), Cooter (1995), Daintith and Teubner (1986), De Geest (1995), Donohue III (1988) with a comment by Posner (1988b), Johnston (1990). Entire issues of the *European Journal of Law and Economics* (EJLE) and of the *Wisconsin Law Review* (Wisconsin) have been devoted to the matter. The link would seem only natural to sociologists such as Boudon (1977), James Coleman (1987, 1988, 1990a, 1992) and Opp (1979, 1982, 1983, 1988, 1991), who subscribe to the postulate of methodological individualism.

Posner (1988b, 1989, 1995b) is not impressed with what legal sociologists have offered by way of understanding legal phenomena: 'The theories proposed by American sociologists of law, when they propose theories, which is not often, tend to be partial and ad hoc and difficult to test empirically, and modern methods of statistical inference are only rarely in evidence'. He adds that the sociology of law is characterised by 'a dearth of arresting hypotheses to set off against the Coase theorem, the Hand formula, the efficiency theory of the common law, the Modigliani-Miller thesis, the human-capital explanation of

employment at will, Ramsey pricing, agency costs, rent-seeking, the selection hypothesis (that plaintiffs tend to win 50 percent of cases litigated to judgment), the concept of complete contingent contracts, the economics of property rights versus liability rules, the activity level theory of strict liability, the efficient-market hypothesis ...' (Posner, 1995b, p. 273). In line with his observation on too many bells and whistles (Posner, 1989, pp. 60, 62), he has little use for the introduction of sociological ideas into the economic analysis of law. Some sociologists (Cranston, 1977; Griffiths, 1995) are critical of the link between the sociology of law and the economic analysis of law as well, but for different reasons. As Coase (1978) reminds us, only experience will tell whether the economic approach as it is has the comparative advantage it claims over other approaches, or whether 'enriched' forms of it do better.

6. Conclusion

This survey leads to two major findings. The first is that the idea of applying economic concepts to gain a better understanding of law is much older than the current movement, which its proponents date back to the late 1950s. The second finding concerns the current movement. After virtually unquestioned dominance and astonishing success of the Chicago approach in the 1960s and 1970s, since about 1980 practitioners of law and economics no longer sing in a single voice.

With respect to the earlier attempts at law and economics, it should be observed that they had declined by the 1930s and find no clear echo in the current movement, outside the work of modern institutionalists such as Samuels and Schmid. Various reasons are given: their methodology became increasingly fuzzy; in the end they failed to convince lawyers, in the absence of a straightforward methodology and telling insights into the nature of legal phenomena. Perhaps, too, the problems they addressed and the solutions they proposed - generally more government intervention - no longer appeared relevant to the legal community.

These observations feed into the second finding, the astounding variety of viewpoints now represented within law and economics broadly written. Will this cacophony drive law and economics into oblivion? It ought not to, since law and economics of whatever stripe still offers insights into a broad range of legal phenomena from contracts, torts and property to commercial law, constitutional law, criminal law and even family law. The task is to convince lawyers that this is a useful, indeed an essential, supplement to traditional lawyering skills. Where law changes rapidly, as it does in our day, lawyers are inevitably involved in policymaking of some sort. The record of lawyers managing such change on the strength of legal skills and legal practice alone is disappointing at best (Posner, 1987b, pp. 769-771).

But can the policy advice proffered by lawyer-economists be relied on? De Alessi (1996, 1997) has formulated a scathing attack on the use of the potential compensation (Kaldor-Hicks) criterion in applied studies and the use of the neoclassical equilibrium model for policy recommendations: 'Actual market solutions in a world of limited private property rights and positive transaction costs always appear to be inefficient relative to some ideal. The result is a bias toward government action to impose rules that, supposedly, move the system toward the ideal. As the application of economics to the analysis of public choices has shown, generations of economists have provided the rhetoric used by rent-seekers in both the private and the public sectors to coopt government regulation and redistribute income to themselves' (De Alessi, 1996, pp. 115-116). To the traditional lawyer, no more is needed to discredit law and economics. For law and economics to prosper, the mainspring of ideas, which is economics proper, must get its house in order (Boettke, 1997).

What then should be the agenda? On the theory of law and economics, Becker's sombre observation is that 'lately, there has been less excitement, less novelty' (Roundtable, 1997, p. 1137). But that, in his view, may be part of the life cycle of scientific theories. In the meantime basic ideas should be absorbed by the practitioners of the discipline. And here lawyers may well ask of law and economics the question Becker put earlier in his remarks: 'What have you done for me lately?' (Roundtable, 1997, p. 1137).

Lawyer-economists must convince lawyers, and even more judges, of the promise of their discipline. They must do this while avoiding being mere rent-seekers on a fad; they must establish the credibility of law and economics as an accurate description of how legal institutions actually work, as well as a generator of hypotheses and insights about law. Cutting through the thicket of established legal doctrine and proposing simpler explanations is one way of doing this. Epstein (1995) is a fine example of that approach. Engaging in empirical work, some of it in the form of historical and comparative studies, is the complementary approach. Only such studies will sort out the debates raging between the various 'schools' of law and economics, as they must be.

Lawyer-economists must distil a straightforward method for applying the economic analysis of law to given legal institutions. Perhaps the method is not always simple and may require a serious learning effort. It should be teachable as a more or less scientific process rather than as a mere art (Katz, 1998, p. v). The benefits of climbing the learning curve should be clear from applications which are telling to lawyers (rather than to economists alone).

One of the remarkable insights coming out of law and economics is that many institutions essential to the functioning of civil society 'have a claim to validity which is independent of specific enactment' (Barry, 1996, p. 617). The institutions produced in the course of evolutionary processes need not be the best conceivable and we may consider reforming them (Buchanan, 1977, p.

131). But unnecessary and ill-timed interference can do great harm; reform should be undertaken warily and on the basis of the best knowledge available. All theories may turn out to be misguided in the face of later research. Practical policy decisions must be made on the basis of such imperfect knowledge. How essential law and economics is may be gleaned from the experience in Middle and East European countries after the restoration of democracy. Advice about what institutions to create appears to have been given often by economists without appreciation for the dynamics of the law and by lawyers with too little knowledge of the workings of the economy. The pains of transition have been prolonged as a result.

Lawyer-economists should only presume to offer policy advice to minister to the ills of society as the discipline acquires solid empirical bearings. It is not sufficient to criticise accepted wisdom and to propose plausible enrichments of the theory, as the debates around 1980 have done. The crucial point is for the discipline to engage in empirical work capable of disproving false tenets. Only in this way can we hope to discover what is indisputable in law and economics, and make its message last. We shall see whether Coase was right in his assessment that '[i]ndeed, work is going forward at such a pace that I do not consider it overoptimistic to believe that the main outlines of the subject will be drawn within five or ten years.' (Coase, 1994, p. 12).

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