CHAPTER 1

Introduction

> courts in their function of declaring, clarifying and extending legal principle must take seriously the economic consequences of what they are doing.[1]
>
> Hon. Mr Justice Kirby, 1998

The common law is the core of the British legal system and that of over fifty other countries originally under British rule. It is one of the great legal systems, and one whose basic principles provide the core of today's open and free societies (table 1.1). Yet the common law is also an enigma – seen as an engine of wealth maximisation and economic freedom but at the same time opaque and shrouded in ambiguity. It is in the eyes, even of many lawyers, incoherent, irrational and frequently 'unfair'. In this, some say, it shares many of the attributes of the marketplace.

This book applies economics to the common law. It has two objectives – to show how economics has and can be used to study law; and to undertake specific analyses of the common law of property, contract, tort and crime. It is an example of the general field known as 'the economic approach to law', or simply 'law and economics'. This is the application of economic theory and quantitative techniques to analyse the rules and remedies of the law.

The economic approach to law is not confined to areas of law which have economic objectives but to all areas of the common law and beyond to family, crime and procedural law and institutions, where the economic content is not apparent. In essence, the economic approach uses 'the principle of economic efficiency as an explanatory tool by which existing legal rules and decisions may be rationalised or comprehended'.[2] Clearly, the economic

[1] M. D. Kirby, 'Comparativism, Realism and the Economic Factor – Fleming's Legacies', in N. J. Mullany and A. M. Linden (eds.), *Torts Tomorrow: A Tribute to John Fleming*, North Ryde, NSW: LBC Information Services, 1998.

[2] J. L. Coleman, 'Efficiency, Exchange and Auction: Philosophical Aspects of the Economic Approach to Law', 68 *California Law Review*, 221–249 (1980) 221.

Table 1.1 *Common law countries*

Africa	Asia	Pacific rim	Caribbean	Europe	North America	South America
Botswana	Bangladesh	Australia	Anguilla	Cyprus	Canada	Falkland Islands
Ethiopia	Hong Kong	Fiji	Bahamas	Ireland	United States	Guyana
Ghana	India	New Zealand	Barbados	England		
Kenya	(Iran)	Papua New Guinea	Belize	Wales		
Lesotho	Israel	Samoa	Bermuda			
Malawi	Malaysia	Solomon Islands	British Virgin Islands			
Namibia	(Nepal)		Cayman Islands			
Nigeria	Pakistan		Dominica			
Sierra Leone	(Saudi Arabia)		Grenada			
South Africa	Singapore		Jamaica			
Tanzania	Sri Lanka		Montserrat			
Tonga	Thailand		St Kitts & Nevis			
Uganda	(United Arab Emirates		St Vincent & Grenadines			
Zambia	(Yemen)		Trinidad & Tobago			
(Zimbabwe)			Turks & Caicos Islands			

Note: Countries in brackets have mixed legal origins which include elements of the common law. In addition there are a number of smaller jurisdictions which have mixed legal systems with a strong common law element such as Jersey, and Guernsey (Norman/common law), Isle of Man and others
Source: World Bank, *Doing Business in 2004 – Understanding Regulation*, New York: Oxford University Press, 2004; T. H. Reynolds and A. A. Flores (eds.), *Foreign Law Current Sources and Legislation in Jurisdictions of the World*, Fred B. Rothman & Co., 1991.

approach will not be admissible in court, nor is it used or referred to by judges. However, it can assist in understanding and critically assessing the law. Instead of relying on judicial analysis and reasoning it offers the legal scholar an external framework which cuts through judges' linguistic formulations. Concepts such as choice, tradeoffs, incentive effects, **marginal analysis**, externalities, the **cheapest cost avoider** and others form the basis for each discussion of the law. It treats different areas of law in terms of the same functional categories, such as distinctions between care and activity levels, alternative and joint care, accidents between strangers and those occurring in situations where the parties have a pre-existing 'exchange' relationship. It provides a treatment of the common law which holds out the prospects of the unification of its disparate areas.

A SHORT HISTORY OF LAW AND ECONOMICS

Over the last four decades the economics of law has penetrated mainstream legal[3] and economics scholarship and has grown in scale, scope and depth. In the USA, where the subject was first developed, law and economics is now well established in most universities, and has recently spread across Europe and to civil law countries.[4]

The 'birth' of the modern law and economics movement can be dated around the early 1960s with the founding of the *Journal of Law and Economics* under the editorship of Aaron Director and then Ronald Coase.[5] Two articles during this period stand out as establishing the foundations of the economic approach to law – Ronald Coase's 'The Problem of Social Costs'[6] (hereafter, 'Social Costs'), and Guido Calabresi's 'Some Thoughts on Risk Distribution and the Law of Torts'.[7]

'Social Costs' is both the most cited and most misunderstood article in law and economics.[8] This is because it develops a number of themes.

[3] In the UK, see H. G. Beale, W. D. Bishop and M. P. Furmston, *Casebook on Contract*, 4th edn., London: Butterworths, 2001; B. A. Hepple and M. H. Matthews, *Casebook on Tort,* 3rd edn., London: Butterworths, 1985; D. Harris, D. Campbell and R. Halson, *Remedies in Contract and Tort*, 2nd edn., London: Butterworths, 2002; A. Clarke and P. Kohler, *Property Law – Commentary and Materials*, Cambridge: Cambridge University Press, 2005.

[4] Such as the Masters Programme in Law and Economics, involving participating universities of Bologna, Hamburg, Rotterdam Ghent, Hamburg, Aix-en-Provence, Haifa, Linköping/Stockholm, Madrid, Manchester and Vienna, see www.frg.eur.nl/rile/emle/universities/index.html. R. van den Bergh, 'The Growth of Law and Economics in Europe', 40 *European Economic Review*, 969–977 (1996).

[5] E. Kitch (ed.), 'The Fire of Truth: A Remembrance of Law and Economics at Chicago, 1932–1970', 26 *Journal of Law & Economics*, 163–234 (1983).

[6] 3 *Journal of Law & Economics*, 1–55 (1960).

[7] 70 *Yale Law Journal*, 499–553 (1967).

[8] Coase's paper is the most cited paper in US law journals, outstripping the next most cited article by two to one. F. R. Shapiro, 'The Most-cited Law Review Articles Revisited', 71 *Chicago Kent Law Review*, 751–779 (1996).

To the economist, 'Social Costs' was an attack on **market failure** as a framework for policy analysis. Economists habitually then used, and still now use, the 'perfectly competitive market' as a benchmark to evaluate economic performance. Market failure was declared if there was any departure from the perfectly competitive market outcome, and the economist would, as almost a reflex action, recommend corrective government intervention. The problem was that this assumed that governments operated costlessly to promote a more efficient outcome. The absence in the economists' world of government failure clearly biased the analysis in favour of state intervention. To paraphrase one wag, only economists could be so naïve as to believe, let alone make practical policy recommendations based on the assumption that politicians and public servants were efficient. 'Social costs' stated that one had to take into account the costs, distortions and inefficiencies of laws and government before any policy conclusions could be drawn.

Coase's criticisms were, however, more profound. He noted that there was an implicit assumption at the heart of the textbook model of perfect competition – that of zero **transactions costs**. Under this assumption, markets simply could not fail – and, further, neither could capitalism, central planning, socialism and regulation. All were equally efficient. The economists' model provided no basis for selecting laws, or an economic system, or even to explain why firms exist or why capital hires labour and not the other way around.

Coase's conclusion was even stranger. He went on to show that irrespective of the legal position regarding harmful activities (more technically called external costs or effects) – such as pollution and road accidents – the law did not affect the efficient solution or market operation. This became known as the '**Coase Theorem**'. It states that in a world of zero transactions costs – where the costs of using the marketplace are negligible – the initial assignment of property rights does not affect the efficient allocation of resources. Thus whether or not the law holds a polluter liable for the harm, the efficient outcome would be generated by the gains from trade available to the parties, not the legal position. That is, market failure was not possible under conditions of perfect competition.

The Coase Theorem generated considerable controversy,[9] striking some as implausible, others as a tautology and many as irrelevant. But its central

[9] Stigler describes the initial reception to the Coase Theorem by twenty Chicago economists at a drinks party at Aaron Director's home: 'We strongly objected to this heresy . . . In the course of two hours of argument the vote went from twenty against and one for Coase to twenty–one for Coase. What an exhilarating event!' G. S. Stigler, *Memoirs of an Unregulated Economist*, New York: Basic Books, 1988.

message was initially misunderstood. It was not that law was irrelevant but that it was relevant to an economist because of the existence of positive transactions costs: a factor that economists had hitherto ignored. Coase went on to advocate the study of the world of positive transactions costs, not as many of his critics seemed to believe a perfect frictionless model. Coase's emphasis on transactions costs, a theme he had developed nearly three decades earlier in his analysis of the firm,[10] spawned a variety of economic approaches to institutional analysis such as the New Institutional Economics (NIE),[11] and related work on **principal–agent problems**, and incentive analysis.

Coase's 'Social costs' also attracted the interest of lawyers because it used the English and US laws of trespass and nuisance to illustrate the effects of legal rules when transactions costs were negligible, and when they were prohibitively high. To many, Coase appeared to argue that common law judges had a better grasp of economic theory (and reality) than most economists. The legal notion of reasonableness which runs through the common law was, suggested Coase, possibly a closet version of the economists' concept of **(Kaldor–Hicks) efficiency**. Thus at one level the Coase Theorem was interpreted as a market manifesto; at another that the common law had an underlying economic logic, a theme that would be picked up by later scholars. That Coase did not actually say nor mean either mattered little to the debate which subsequently raged.

In 1967 Guido Calabresi's article 'Some Thoughts on Risk Distribution and the Law of Torts'[12] was the first systematic attempt by a lawyer to examine the law of torts (essentially, accident law) from an economic perspective.[13] Calabresi, a professor at Yale Law School but who had economics training, argued that the goal of accident law should be to 'minimise the sum of the costs of accidents and the costs of preventing accidents'.

Calabresi refined this axiom into a normative theory of legal liability (tort) and public policy for accident losses: the costs of accidents could be minimised if the party who could avoid the accident at least cost was made liable for the loss – i.e. pay compensation. This Calabresi called

[10] R. H. Coase, 'The Theory of the Firm', 4 *Economica*, NS 386–405 (1937), reprinted in R. H. Coase, *The Firm, The Market, and The Law*, Chicago: University of Chicago Press, 1988.

[11] O. E. Williamson, 'The New Institutional Economics: Taking Stock, Looking Forward', 38 *Journal of Economic Literature*, 595–613 (2000); O. E. Williamson, *The Economic Institutions of Capitalism*, New York: Free Press, 1985; International Society for New Institutional Economics, www.isnie.org.

[12] 70 *Yale Law Journal*, 499–553 (1967).

[13] Mention should be made of P. S. Atiyah's *Accidents, Compensation and the Law*, London: Weidenfeld & Nicolson, 1970, which introduced the British law teacher and student to Calabresi's economics and was the first serious work by a British lawyer placing law in its wider social and economic context.

the 'cheapest cost avoider'.[14] His idea was simple, and easily illustrated. A careless driver collides with a pedestrian, inflicting expected damages totalling £200. It is discovered that the accident resulted from the driver's failure to fit new brakes costing £50. Clearly, road users and society as a whole would be better off by £150 if the driver had fitted new brakes: a sum equal to the avoided loss of £200 minus the cost of the new brakes, £50. If the driver is made legally liable for the loss – that is, she is required to pay the victim compensation of £200 should an accident occur – then she would have a strong incentive to fit the new brakes. A liability rule which shifted the loss whenever it encouraged careless drivers to fit new brakes would make the efficient solution the cheapest for the negligent motorist. 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.

The fuse lit by Coase and fanned by Calabresi, ignited in US law schools with the work and views of Richard Posner in the 1970s. Beginning with his paper, 'A Theory of Negligence',[15] and refined in later articles and books, a new branch of the economic analysis of law was ushered in, one that the lawyer could use to analyse and rationalise the hotchpotch of doctrines which made up the common law. Posner's approach differed from Calabresi's normative analysis; his was a positive theory designed to 'explain' the common law. Posner advanced the radical and highly controversial thesis that the fundamental logic of the common law was economic; that its doctrines and remedies could be understood 'as if' judges decided cases to encourage a more efficient allocation of resources. If true, this would be a finding of great legal and empirical significance. The idea that economics could unlock the logic of the common law raised its profile among legal scholars, who were either attracted or repelled by the proposition.

Posner had shrewdly tapped into the primary reasons for the failure of economics to make inroads into legal scholarship – or, indeed, impress lawyers. It simply did not address the everyday questions that lawyers and law teachers dealt with. The question – Does tort deter accidents? – is of no importance to the law teacher, if the object is to explain and organise the court's decisions and reasoning. Put crudely, the lawyer and law teacher were apt to argue that if judges did not give economic reasons for their decisions, economic analysis of those decisions was not useful. It was

[14] G. Calabresi, *The Costs of Accidents: A Legal and Economic Analysis*, New Haven: Yale University Press, 1970.

[15] R. A. Posner, 'A Theory of Negligence', 1 *Journal of Legal Studies*, 28–96 (1972); W. M. Landes and R. A. Posner, *The Economic Structure of Tort Law*, Cambridge, MA: Harvard University Press, 1988.

clear that to introduce economics to law and lawyers it was necessary to show that it would help in understanding both legal doctrines and the law itself.

Posner not only brought the legal camels to water, but made them drink. His main contribution was to show that simple economic concepts could be used to analyse the law in the way that lawyers traditionally looked at their subject – that is to, 'explain' the rules and remedies of contract, property, criminal, family, commercial, constitutional, administrative and procedural laws. His text *Economic Analysis of Law*, first published in 1973 and now in its sixth edition, was and remains a *tour d'horizon* of the economics to law.[16] The view, which (now) Chief Judge Posner still firmly holds, is that:

> One of the major contributions of economic analysis to law has been simplification, enabling enhanced understanding. Economics is complex and difficult but it is less complicated than legal doctrine and it can serve to unify different areas of law. We shall demonstrate how economics brings out the deep commonality, as well as significant differences, among the various fields of . . . law . . . Economics can reduce a mind-boggling complex of statutes, amendments, and judicial decisions to coherence. By cutting away the dense underbrush of legal technicalities, economic analysis can also bring into sharp definition issues of policy that technicalities may conceal.[17]

Others were, and remain, unconvinced.

The 1970s and 1980s were the growth decades of the law and economics movement, at least in the USA.[18] Increasingly, North American legal scholars began to use economics to rationalise and appraise the law and by the 1980s the movement had firmly established itself as a respectable, albeit controversial, component of legal studies. In the USA many prominent scholars in the field (Bork, Breyer, Calabresi, Easterbrook, Posner and Scalia) were appointed judges, and economics – especially supply-side economics – was thrust to the forefront of the political agenda by reforming governments in both West and East.[19]

[16] R. A. Posner, *Economic Analysis of Law*, Boston: Little Brown, 1973; 6th edn., Gaithersburg, MD: Aspen Publishers, 2003.

[17] W. Landes and R. A. Posner *The Economic Structure of Intellectual Property Law*, Cambridge, MA: Harvard University Press, 2003, 10.

[18] W. M. Landes and R. A. Posner, 'The Influence of Economics of Law: A Quantitative Study', 36 *Journal of Law & Economics*, 385–424 (1993). This study finds that the influence of economics on US law was growing through the 1980s but that the rate of growth slowed after 1985.

[19] In March 1993 the *Journal of Economic Literature* published by the American Economics Association introduced 'Law and Economics' as a separate classification, formally recognising the field among economists.

LEGAL VS ECONOMIC REASONING

It will not surprise the reader to learn that lawyers and economists think in different ways. These differences explain both the resistance often encountered to the economics of law, and the contributions the latter can make.

The central difference between legal and economic reasoning is that lawyers look at the past, economists the future. This can be portrayed as a difference between the *ex post* analysis of lawyers concerned with rights, corrective justice and adjudicating disputes, and the *ex ante* or incentive analysis of economists. This distinction needs some explanation.

The lawyer typically begins with a dispute and a loss which has to be resolved. The approach is case by case and focuses on the distributive issue of how to (re)-allocate a given loss between the two or more parties to the dispute. Given this focus, and the professional skills that lawyers have to acquire, law tends to be seen through a narrow lens. There is no necessity to develop either a theory of law or a broad view of its social and/or economic effects. These are simply irrelevant to applying and to understanding the law. Moreover, the wider effects are not likely to be part of the lawyer's experience. If the law is successful in deterring wrongdoing, accidents or crime, it means that a legal dispute has been avoided. In short, successful laws mean less business for lawyers!

The economic approach differs from this practical process of applying law to cases. For the economist, the past is a 'sunk' cost. The economist does not view law as a set of rights and remedies but a system of incentives and constraints affecting future actions. As a consequence, the economists' primary focus is on the wider repercussions of the law on all potential litigants and individuals likely to find themselves in similar circumstances. To use Bruce Ackerman's description, the economic approach requires the lawyer to 'reconstruct the facts' to an earlier period before the dispute when the parties could have reorganised their activities.[20]

As an example, consider a careless driver who has knocked down and injured a pedestrian. The issue confronting the court involves a past event and a loss. This loss cannot, obviously, now be avoided, it can only be shifted by the judge. But the judicial shifting of losses has effects on future victims and injurers, either by altering their behaviour or their post-injury decision whether to litigate or settle the case out of court. Thus, while the lawyer will focus on the actions of the parties to an accident to allocate 'fault', the economist will examine the way that the court's decisions affect

[20] B. Ackerman, *Reconstructing American Law*, Cambridge, MA: Harvard University Press, 1984.

the accident rate, accident costs and the court's case-load. The economist is concerned with the effect that rules have on behaviour *before* the mishap.

THE COMMON LAW

It will strike the lawyer as odd, if not implausible, that economics can and indeed should be used to interpret law. This is particularly so since judges and the law rarely use economics or economic reasoning. It is almost unknown for an English judge today to draw on economics, although this was not unusual in cases in the nineteenth century.

One can understand that it may be useful to know as a policy matter what the effects, costs and benefits of different laws are and their alternatives, but not to interpret the law. The reason why this is possible and plausible lies in the nature of the common law – and, indeed, law itself.

Structure of the common law

Let us begin by describing the main features of common law adjudication.

First, it relies on private enforcement: that is, the parties to an accident or dispute must litigate their claims and fund the costs of litigation and out of court settlements.

Second, disputes are adjudicated by an independent judiciary in adversarial proceedings. The parties – known as the plaintiff but now called the claimant under recent reforms in England and Wales, and the defendant – must present their claim and defence, respectively, to the court. The burden of proof is placed on the claimant to establish that the alleged harm is on the balance of probabilities a legal wrong and it is for the defendant to counter these allegations. The proceedings are said to be adversarial, involving a legal 'contest' before a judge and contrast with most other European civil legal systems where the judge elicits the facts and questions the parties (known as an inquisitorial system).

Third, the common law offers a limited range of remedies which are confined to enforcing the parties' rights or compensating them for their losses. The typical remedy is compensatory damages, which aim to restore the claimant to the position he or she would have been in had the wrong not occurred. In more limited circumstances, the courts may offer an injunction to prohibit or force a party to do something or, in contract disputes, specific performance requiring the party to honour the contract. Courts cannot impose more general penal sanctions such as fines or

imprisonment, and can only rarely impose damages in excess of a genuine pre-estimate of the claimant's losses (except in contempt of court).

Fourth, the common law often denies those harmed a remedy. It is generally based on a fault liability or other judgmental standard governed by the conduct of both parties. The law also often provides the defendant with a number of defences or excuses which allow him or her to avoid paying compensation. This means that the common law does not operate as a general (universal) compensation or insurance scheme.

Finally, because of the costs and uncertainty of litigation, an overwhelming proportion of legal disputes and potential cases are settled out of court or abandoned. The proportion of cases coming to court that are meritorious probably numbers a few per cent. That is, litigation is a last resort – or, as is now often said, the common law encourages 'bargaining in the shadow of the law'.[21]

To the above features must be added the way law evolves in common law legal systems. Common law is often described as judge-made law. This is something judges would dispute since they regard themselves as discovering already existing law which they apply to new fact situations. Nonetheless, the common law has evolved over centuries through the decisions of judges in individual cases. These cases – or, rather, the legal precedents they set – create a body of law which must be distilled from the written decisions of judges and, when distilled, must be applied to new cases with different facts. It is, to use a contemporary term, 'bottom-up law' created in an evolutionary and practical way to resolve disputes. This contrasts again with the civil law systems of the rest of Europe, which are based on legal codes devised by governments.

It is also the case that common law judges rarely state general principles of law. Common law has been described as a system of law which places a particular value on dissension, obscurity and the tentative character of judicial utterances so 'that uniquely authentic statements of the rule . . . cannot be made'.[22] The linguistic formulations used by judges such as 'duty of care', 'reasonable foreseeability', 'proximity', and 'reasonable care' have a chameleon-like quality. They are frequently used interchangeably, confusing lawyer and judges alike. The result is that the general principles of English common law are open-ended. '[T]he conceptual

[21] The expression is from R. Mnookin and M. Kornhauser, 'Bargaining in the Shadow of the Law', 88 *Yale Law Journal*, 950–997 (1979).

[22] B. Simpson, 'The Common Law and Legal Theory', in W. Twining (ed.), *Legal Theory and Common Law*, London: Blackwell, 1986, 17.