

# An Introduction to Law and Economics

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*This paper reviews the evolution of law and economics scholarship, and identifies different styles of economic analysis of law by emphasising the basic distinction between positive and normative analysis. By way of illustrating the economic approach to law, the paper emphasises the way economics approaches the two legal building blocks of a system of private ordering ie, private property rights, and freedom of contract. The paper goes on to illustrate the wide range of legal issues that have attracted attention from law and economics scholars over the last decade or so. The paper concludes by adopting a comparative systems approach to allocational issues by taking the example of scarce life-saving technology and examining how markets, lotteries, queues, voting systems, and administrative forms of merit allocation might deal with the allocational problem, and the strengths and weaknesses associated with each allocational model.*

## A CONCEPTUAL OVERVIEW OF THE ECONOMIC PERSPECTIVE ON LAW

### Intellectual History

Many of the great political economists of the past, such as Adam Smith, Jeremy Bentham, John Stuart Mill, and Karl Marx understood the intimate relationship between the configuration of a country's legal system and the configuration of its economy. One of the great ironies in the evolution of intellectual disciplines over the past century or so is that the theory of the gains from specialization, which Adam Smith argued so persuasively for in the economy at large in *The Wealth of Nations* in 1776, and which he defied so spectacularly in the sweep of his own work, has been adopted, with largely unbridled enthusiasm, in many scholarly disciplines. For example, until recently, much legal education and research has tended to ignore the impact of a country's legal system on its economy, and the reverse — the impact of economic forces on the operation of its legal system. Equally, modern economics, with its predilection for very abstract mathematical modelling of fine theoretical issues, has tended to underemphasize institutional factors that bear on how an economy, or sectors of it, are actually likely to function in the real world.

Prior to 1960, most North American law schools paid attention only to anti-trust, public utility regulation, and perhaps tax policy from a law and economics perspective (sometimes referred to as the 'old' law and economics). However, beginning in the early 1960s with pioneering articles by Guido

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Calabresi<sup>1</sup> on tort law and Ronald Coase<sup>2</sup> (the 1991 Nobel Prize winner in economics) on property rights, followed by prolific writings and a comprehensive text by Richard Posner<sup>3</sup> on a vast range of legal issues, the field of law and economics has burgeoned with many lawyers and economists around the world now exploring the economic implications of almost every aspect of the legal system. The 'new' law and economics is often as much interested in non-market as market behaviour to which the 'old' law and economics largely confined itself. This development has been accompanied by the initiation of a number of specialised law and economics oriented scholarly journals, and the appointment or cross-appointment of professional economists to the faculties of most major North American law schools. In turn, within their own discipline, economists have recently revived an institutional tradition with the emergence of fields such as public choice theory (which models collective decision-making eg politics, in a rational, self-interested actor framework) and transaction cost economics (which attempts to explain alternative contractual and organisational structures in terms of the relative costs of economic coordination associated with each).<sup>4</sup> The emergence of economic analysis of law has not only attracted many followers, but has also provoked intense controversy, and in this latter respect can claim some credit for helping to reinvent competing perspectives on law.

In this essay, I will review the distinctive characteristics of the major forms of law and economics scholarship, both positive and normative, suggesting the kinds of insights that each form can contribute to legal scholarship, but also indicating the major limitations of the perspective. I then illustrate some of the strengths and limitations of the economic analysis of law in two areas of law of central importance to market economies — property rights and contract law. I then briefly review some of the vast range of issues in other areas of law that have been addressed in law and economics scholarship. I follow this review with a comparative systems analysis of an illustrative allocative problem — allocating scarce life-saving technology — to highlight the virtues and vices of alternative allocative mechanisms in any society. I conclude the essay by making a constrained and, I hope, modest claim for the contributions of economic analysis of law. I believe that making Panglossian or imperialistic claims for a particular theoretical perspective is likely to lead to its being discredited and disserved, while acknowledging its limitations is not to reject all utility to the perspective. I doubt that other major theoretical perspectives can fairly make grander claims.

<sup>1</sup> G Calabresi, 'Some Thoughts on Risk Distribution and the Law of Torts' (1961) 70 *Yale LJ* 499; G Calabresi, *The Costs of Accidents* (1971).

<sup>2</sup> R Coase, 'The Problem of Social Costs' (1960) 3 *J L & Econ* 1.

<sup>3</sup> R Posner, *Economic Analysis of Law* (4th ed, 1992).

<sup>4</sup> See generally on the history of law and economics scholarship, C Veljanovski, *The New Law and Economics* (1982); E Kitch, 'The Fire of Truth: A Remembrance of Law and Economics' (1982) 33 *J Leg Educ* 184.

## Positive and Normative Economic Analysis

The central preoccupation of economics is the question of choice under conditions of scarcity. Given scarcity, economics assumes that individuals and communities will (or should) attempt to maximise their desired ends (which may be of infinite variety) by doing the best they can with the limited resources (means) at their disposal. To the extent that means (or resources) can be made relatively less scarce, or stretched further, more ends or goals of individuals or communities can be realised. Obviously, the legal system, in important ways, structures the choices available to individuals and groups in a whole range of settings. In analysing issues of choice under conditions of scarcity and subject to other constraints, including constraints imposed by the legal system, law and economics scholarship employs two conceptually different kinds of analysis.<sup>5</sup> The first style of analysis is conventionally referred to as positive analysis, meaning descriptive or predictive analysis. The second style of analysis is normative analysis, meaning prescriptive or judgmental analysis. The first kind of analysis tends to be much less controversial than the second.

### *Positive Analysis*

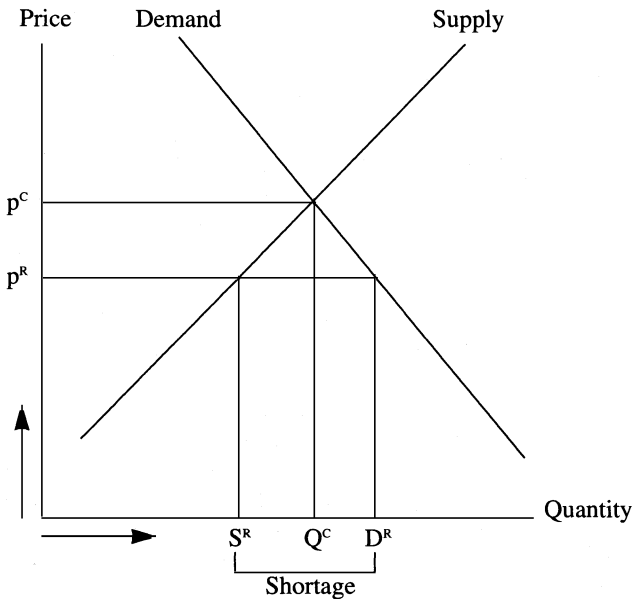
#### *A. Impact Analysis*

With respect to positive economic analysis of legal issues, the analyst tends to ask the following kind of question: if this (legal) policy is adopted, what predictions can we make as to the likely economic impacts, allocative (the pattern of economic activities) and distributive (winners and losers), of the policy, given the ways in which people are likely to respond to the particular incentives or disincentives created by the policy? In predicting these behavioural responses, the positive analyst will assume that most individuals are motivated by rational self-interest, in the sense of maximising their individual utilities subject to whatever constraints are imposed on the choices open to them. That is to say, rational (cost-minimising) means will be chosen to further any given set of ends. Utility functions may be infinitely varied. Mother Teresa and her successors may be motivated out of pure altruism to buy rice on the best possible terms from rice dealers in order to feed starving children in the streets of Calcutta. Another person may be motivated out of a desire to sustain a decadent life style to buy narcotics for dealing to drug addicts, causing enormous human suffering as a result. In conventional supply and demand analysis, it is assumed that in most contexts more goods or services will be supplied at higher than lower prices, and that fewer goods or services will be demanded at higher prices than lower prices — supply curves slope up to the right, demand curves slope down to the right. How sensitive supply and demand will be to changes in prices (the elasticity of supply and demand) will largely depend on substitution possibilities open to suppliers and demanders. Supply and demand curves are flatter the more elastic (price sensitive) they are. Even the supply of altruism is likely to be inversely related

<sup>5</sup> Posner, *op cit* (fn 3) chs 1 & 2; Veljanovski, *ibid* (fn 4) 3.

to its cost — more blood is likely to be supplied altruistically than steak and potatoes. Thus, positive economic analysis is individualistic and subjective in its behavioural premises. For example, a positive analyst of legal issues back in the nineteen-twenties might have asked what behavioural responses on both the supply and demand sides would one predict by way of reaction to Prohibition laws? Similar questions might be asked today about various features of the war on drugs. Or the analyst might ask what kind of first and second-order behavioural responses might one predict to rent control laws, or agricultural marketing board regimes that impose price floors and production quotas on producers, or minimum wage laws, or cost plus regulation of public utilities, or exclusive dealing contracts, or the adoption of strict products liability over negligence, etc. Understanding the incentives effects of these various legal regimes is a necessary prelude to formulating normative judgments as to the merits of the regime under analysis relative to alternative policies that might be employed to pursue the same or alternative social goals.

Perhaps two examples from this list will help to illuminate the predictive implications of the basic relationship between demand and supply functions. First, let us take the case of rent controls. Assume that out of concern for affordability, government imposes rent controls on rental accommodation to force rents down below the rate that would otherwise prevail in an unregulated market. The impact of the intervention might be graphed as follows:



**Figure 1:** rent controls

### Rent Controls

At the competitive price ( $P^C$ ), quantity  $Q^C$  will be demanded and supplied. At the regulated price ( $P^R$ ),  $D^R$  will be demanded but only  $S^R$  will be supplied, yielding a shortage of rental accommodation of  $D^R - S^R$ . With this initial disequilibrium in the market, economists would predict the following behavioural responses on the demand side. Prospective tenants will offer key money to obtain accommodation. Incumbent tenants will charge premiums on subletting. Incumbent tenants will be less mobile in labour markets, given the costs of leaving a rent controlled apartment and the prospects of extensive search costs and queues in finding alternative accommodation in new work locations. Some incumbent tenants will benefit from the controls even though they may be well endowed — perhaps better endowed than some landlords. On the supply side, economists would predict that some landlords will attempt to extract key money from prospective tenants; will reduce investments in maintenance; will impose ‘adult only’ conditions in leases to reduce wear and tear costs; perhaps indulge a taste for racial discrimination in clearing queues of prospective tenants (economics *is* sensitive to the existence of non-pecuniary sources of utility); or withdraw units from rental markets or convert to condominiums or co-operatives. Some of these effects can be partly contained by additional regulation, but are unlikely to be entirely eliminated. Generally, the realignment of incentives is easier than applying constraints on behaviour.

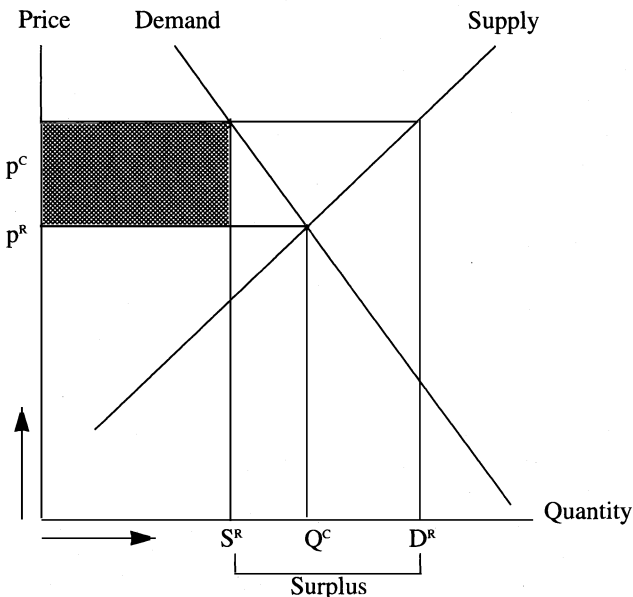


Figure 2: agricultural marketing boards

Let us now take the case of agricultural marketing boards that set minimum price floors and maximum production quotas for agricultural products (eg eggs) and that are introduced ostensibly in order to enhance the welfare of small family farmers. The initial impact of the intervention can be graphed as follows<sup>6</sup>

### *Agricultural Marketing Boards*

At the competitive price ( $P^C$ ), quantity  $Q^C$  will be demanded and supplied. At the regulated price ( $P^R$ ),  $S^R$  will be supplied but only  $D^R$  will be demanded yielding a surplus of  $S^R - D^R$ . The function of maximum production quotas is to ensure that producers only produce  $D^R$  so that the market clears. On the demand side, an obvious prediction is that consumers will buy fewer eggs and those that continue to buy eggs will pay more for them, including people of modest means for whom eggs are a staple. On the supply side, assuming production quotas are initially allocated on an historical basis (producers with an established presence in the market), the initial quota recipients will obtain supra competitive returns, measured by the shaded rectangle, at the expense of consumers who remain in the market. To the extent that some of these initial quota recipients are relatively less efficient egg producers, resources devoted to producing  $D^R$  of eggs will be greater than necessary. Quotas might, on that account, be made tradeable to allow more efficient (lower cost) egg producers to produce the eggs demanded at  $P^R$ . Prices paid for the quotas will probably reflect the capitalised value of the future stream of supra-competitive prices (the shaded rectangle). Thus, after paying quota prices, the second generation of egg producers are likely to be making a normal, competitive rate of return on their combined investment in egg production resources and quotas. The end result, it would be predicted, would be an allocatively inefficient industry (too few eggs —  $D^R$  — are produced), but a productively efficient industry (the low cost producers service the market after quota transfers), though arguably a distributively perverse outcome in that while small family farmers receive an initial wealth transfer, current egg producers gain nothing from the scheme, and current consumers, including poor consumers, pay more than they need to for eggs. Moreover, the scheme may be politically irreversible, as current egg producers who may have paid substantial sums for quotas to the initial recipients will strenuously resist any termination of the scheme without full compensation (often referred to as 'the transitional gains trap' problem).<sup>6</sup>

These examples illustrate the fundamental presumption of neo-classical economics: that economic agents, in all their various activities, *respond to incentives*. This proposition is central to understanding the functioning of any pricing system, whether it involves explicit (grocery store) prices, or implicit (penalties for different crimes) prices. To the neo-classical economist, the legal system is simply an institutional arrangement for prescribing, and setting implicit prices for, certain activities, within some over-arching

<sup>6</sup> G Tullock, 'The Transitional Gains Trap' (1975) 46 *Bell J Ecs* 671.

consequentialist objective. It then follows that a crucial aspect of the law and economics scholar's enterprise is the empirical testing of the presumption (ie that agents do indeed respond to the implicit prices specified by the legal system, whether it be in contracts, tort, criminal law, etc). In the opinion of many law and economics scholars, while law and economics is powerful in its own right as an organising and sorting tool, it will ultimately be judged on the empirical validity of its propositions.

In this respect, it is helpful to think of the legal system as analogous to a giant supermarket. Products carry different prices within competing product categories and across different categories. Some products are strong or weak substitutes; some are strong or weak complements. Prices change through time in response to changes in supply and demand conditions. Suppliers and consumers adjust their buying behaviour in the light of relative prices and of changes in relative prices (eg more tomatoes will be bought at lower than higher prices and vice versa). In the case of the legal system, increasing fines for speeding or impaired driving or imposing punitive damages in tort cases for egregious misconduct can be viewed as an increase in relative prices. Raising social assistance or unemployment benefits or subsidies to research and development can be thought of as reducing the relative prices of the qualifying activity. Adopting a no-fault divorce regime obviously reduces the cost of terminating a marriage and may result in a one-time increase in the divorce rate for the current stock of bad marriages (a first-order effect), but it may also raise the long-term divorce rate by reducing the cost (risk) of getting married and hence incentives to invest as many resources in pre-marriage search activities (a second-order effect).

In principle, in all these examples one can predict at least the direction of the effects of a legal change from the basic economic model of human behaviour described above, and also the magnitude of the effects if empirical evidence from similar changes in the past in the jurisdiction in question on other comparable jurisdictions is available from which to infer elasticities of supply and demand (as with supply-side and demand-side responses to changes in the price of tomatoes) (not all actors will be equally sensitive or insensitive to price changes, so that one measures effects at the margin).

### *B. Positive Theories of Legal Doctrine*

A provocative thesis that has been advanced in some law and economics literature is that the common law exhibits a general tendency to the evolution of economically efficient rules. This purports to be a positive (descriptive) rather than normative (prescriptive) theory of the common law process. The thesis is grounded in various ways. One variant<sup>7</sup> argues that elected officials, who are accountable politically to their constituencies, face incentives in order to secure election or re-election, to espouse policies that will attract the support of a sufficient number of salient political interests, whatever the over-

<sup>7</sup> Posner, *op cit* (fn 3) chs 8 & 19; Posner, 'The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication' (1979) 8 *Hofstra L Rev* 487.

all economic impact of those policies. In contrast, it is claimed that judges who do not face these incentives are more likely to adopt rules that are broadly consonant with the general public interest. Moreover, typical common law adjudications in two-party litigation are claimed not to be conducive to the realisation of broad redistributive policies. Thus, efficiency as an objective function is attributed to judges largely by default, given the absence of alternative political incentives and effective instruments for effectuating systematic redistributive goals. Hence, the common law courts are viewed as maximising a broad social welfare function, while politicians and their delegates (for example, bureaucrats and regulators) are viewed as captives of factional politics involving competition and conflict among distributional coalitions. On this view, the common law will tend to be concerned with efficiency, the political process with often cynically motivated redistributive objectives.

Another variant<sup>8</sup> of the efficiency of the common law thesis is that without making any attribution of efficiency objectives to common law judges, the process of case selection involved in yielding cases for appellate decision and hence rules of precedential weight will tend to present a biased sample of cases to appellate courts — in particular, inefficient rules or legal outcomes will be appealed more frequently than efficient rules or outcomes — so that even if judges are agnostic about the virtues of efficient rules, the sample bias itself will tend to generate, over time, more reversals than endorsements of inefficient rules. The hypothesis of a sample bias rests on the claim that rules that generate larger social costs than benefits (that is, inefficient rules) create large stakes (hence stronger incentives) in the cost bearers than the beneficiaries to challenge these rules through the appellate process. In other words, the asymmetric costs and benefits of inefficient rules will generate correspondingly asymmetric stakes and incentives in the preservation or repudiation of these rules.

The thesis of the efficiency of the common law is open to various critiques. With respect to the first variant, even though judges do not face the same incentives in their law-making as politicians, it is not clear why, *a priori*, they would be any more minded to adopt efficiency-determined conceptions of the social welfare rather than, for example, particular notions of distributive justice as among sub-groups of the community, or narrower notions of corrective or commutative justice as between the actual parties in conflict in the litigation before the court, or any of a number of other possible objectives. Conversely, in contrasting the common law to legislation, it is not obviously true that legislators will always be driven by narrow interest-group politics but rather, on occasions, may be responsive to widely shared community values or indeed have some ability to forge or shape such values. For example, the enactment of the Criminal Code is not easily explained in terms of narrow special interest group politics, and many other areas of political and legislative activity present similar difficulties of explanation in these terms.

<sup>8</sup> For example P Rubin, 'Why is the Common Law Efficient?' (1977) 6 *J Leg Stud* 51; G Priest, 'The Common Law Process and the Selection of Efficient Rules' (1971) 6 *J Leg Stud* 65; J C Goodman, 'An Economic Theory of Evolution of the Common Law' (1978) 7 *J Leg Stud* 393.



The sample bias variant is also vulnerable to various criticisms. While the costs and benefits of inefficient rules may be asymmetric, it is not clear that these asymmetries will closely track the relative incentives to litigate. For example, fraudulent behaviour on the part of a merchant may generate larger losses in over-all consumer welfare than gains to the merchant, but because the losses are so widely dispersed, the incentives for individual consumers to sue, and if necessary, appeal, to promote the adoption of an efficient legal rule to regulate this behaviour may be highly attenuated — individual losses may be small and the costs of litigation disproportionately high. Similarly, in the case of a firm polluting a neighbourhood, it may not be rational for an individual member of the neighbourhood to sue, and it may be strategically and procedurally difficult to organise the aggregation of individual claims in a collective action. Even where an individual loss from an inefficient rule is sufficiently large to overcome these barriers to suit, if this loss is a one-time event for the cost bearer, but the gain for the beneficiary can be extrapolated over many similar transactions in the future, the latter will have incentives to invest greater resources in attempting to defend the rule.

Moreover, even if the sample bias hypothesis has some validity in the case of common law rules, it would equally appear to have similar validity in the case of legislation. Existing or proposed legislation that generates larger costs than benefits will, on the same reasoning, create larger stakes or incentives in the cost-bearers than the beneficiaries to oppose the legislation in the political arena.<sup>9</sup> Thus, it is not clear that the hypothesis identifies anything unique about the common law.

In sum, the efficiency of the common law thesis, while provocative, is controversial and in various important aspects unconvincing.<sup>10</sup> However, in transaction-oriented areas of commercial law eg contract law, sales law, corporate law, partnership law and international business transactions, the claim has some plausibility because one would assume that commercial parties would simply contract away from legal rules that they found uncongenial (ie not joint welfare maximising), thus marginalizing the relevance of the legal rules, although generating unnecessary transaction costs in the process. Legal rules that, on the other hand, reflect the norms that the parties would have chosen for themselves in the great majority of cases serve the socially useful purpose of reducing the transaction costs otherwise entailed in parties having to negotiate a fully-specified, complete contingent claims contract for themselves. 'Transaction costs' here include the costs of hiring lawyers and drafting a detailed, formal, initial contract covering every conceivable future contingency bearing on the contract, and perhaps re-negotiating the contract from time to time. However, even in transaction-oriented areas of the law, like contract law, the evidence suggests that the presumption that the common law has evolved efficient rules over time is at best only plausible, and appears

<sup>9</sup> J Hirshleifer, 'Evolutionary Models in Economics and Law Cooperation Versus Conflict Strategies' (1982) 4 *Research in Law and Economics* 1, 47.

<sup>10</sup> For an acknowledgment of the limitations of the thesis, and alternative hypotheses and empirical evidence on incentives to litigate, see G Priest & B Klein, 'The Selection of Disputes for Litigation' (1984) 13 *J Leg Stud* 1.

manifestly not to be true in a number of contexts such as, for example, the common law of restraint of trade.<sup>11</sup> Moreover, it is easy to indulge in a methodological slide (a form of the naturalistic fallacy) from the positive observation that the common *is* often efficient to the normative assertion that it *ought* always or often to be efficient, which is a claim that requires independent vindication.

### *Normative Analysis*

With respect to normative economic analysis, again the orientation, as with positive analysis, is individualistic and subjective. This style of analysis — conventionally referred to as welfare economics — would tend to ask the question: is it likely that this particular transaction or this particular proposed policy or legal change will make individuals affected by it better off in terms of how they perceive their own welfare (not as some external party might judge that individual's welfare). In this context, two concepts of efficiency are of central importance: Pareto efficiency (named after an Italian economist writing late in the last century) and Kaldor-Hicks efficiency (named after two British economists writing in the inter-war years of this century). Pareto efficiency would ask of any transaction or policy or legal change: will this transaction or change make somebody better off while making no one worse off? Kaldor-Hicks efficiency, on the other hand, would ask the question: would this collective decision (eg a change in legal rules) generate sufficient gains to the beneficiaries of the change that they could, *hypothetically*, compensate the losers from the change so as to render the latter fully indifferent to it but still have gains left over for themselves. This latter approach is effectively a form of cost-benefit analysis. Let me elaborate a little on these two concepts of efficiency.

Neo-classical economists in general attach strong normative value to regimes of private exchange and private ordering, and often bring some degree of scepticism to bear on the capacity of collective decision makers eg legislatures, regulators, bureaucrats, or indeed courts, to adopt policies or laws that will unambiguously increase net social welfare. This predilection for private ordering over collective decision-making is based on a simple (perhaps simple-minded) premise: if two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel that the exchange is likely to make them better off, otherwise they would not have entered into it. Thus, with respect to most exchanges, the economic presumption is that they make all the parties thereto better off. This presumption is rebuttable by reference to a fairly conventional list of forms of market failure, or in a transaction-specific context, contracting failure, which neo-classical economists recognise as inconsistent with this presumption eg monopoly, externalities, information failures.<sup>12</sup>

In addition to *economic* justifications for the primacy of private ordering, a

<sup>11</sup> M Trebilcock, *The Common Law of Restraint of Trade* (1986) ch 8.

<sup>12</sup> For an excellent exposition and critique of the normative justification for Pareto efficiency, see J Coleman, *Markets, Morals, and the Law* (1988) 97–129.

closely related *political* justification is also often offered by classical liberals or libertarians. As articulated by scholars such as Hayek,<sup>13</sup> Friedman,<sup>14</sup> and Nozick,<sup>15</sup> individual autonomy is seen as a paramount social value and a central precondition to individual freedom. Private ordering is most compatible with this value because it minimises the extent to which individuals are subjected to externally imposed forms of coercion or socially ordained forms of status. Private ordering is the quintessential form of government with the consent of the governed.

With respect to collective decisions which are not the result of voluntary agreement among all affected parties, typically such decisions will generate both winners and losers. The question then becomes whether the *net* effect of these decisions is to increase social welfare as judged by all affected individuals in terms of the impact of such decisions on their levels of present or prospective utility. The central difficulty here is that these impacts on individuals' utility functions are not directly observable by collective decision-makers, and there is no ready way of ensuring accurate revelation by individuals of their evaluation of these impacts, thus rendering the utilities and disutilities associated with such a decision largely incommensurable. For example, suppose that it were proposed that a major new multi-lane highway be constructed through an urban area, generating gains in utility for commuters from more distant areas but losses in utility to inner-city residents immediately adjacent to the throughway. How can decision makers be confident that the net effect on social welfare of a decision to proceed with construction of the throughway will be positive? Similar questions arise with respect to changes in legal regimes which are imposed on affected parties by collective decision and which make some individuals better off and others worse off. How does one go about determining whether the gains in utility to one group exceed the losses in utility to the other? Thus, economists feel much more confident about making welfare judgments about the impact of private exchanges on the parties thereto than the impact of collective decisions on all parties affected by them. However, it should be acknowledged that the initial decision to adopt a market *system* over some other economic system, in contrast to a particular allocational decision within an economic system, requires resort to Kaldor-Hicks rather than Paretian concepts of efficiency, because clearly market *systems* do generate both winners and losers.<sup>16</sup> Even the pecuniary externalities associated with particular transactions within a market system (eg a new entrant competing a rival out of business by attracting away all his customers) can only be ignored by assuming (probably correctly), as neo-classical economists do, that the benefits to the new entrant and his customers exceed the costs to the failed rival (nevertheless a Kaldor-Hicks welfare judgment).

<sup>13</sup> F Hayek, *The Road to Serfdom* (1944).

<sup>14</sup> M Friedman, *Capitalism and Freedom* (1958).

<sup>15</sup> R Nozick, *Anarchy, State and Utopia* (1974).

<sup>16</sup> T Scanlon, 'Liberty, Contract, and Contribution' in G Dworkin, G Bermant and P G Brown, (eds) *Markets and Morals* (1977).

### Limitations of the Economic Perspective<sup>17</sup>

I have sketched a highly simplified explanation for why many economists prefer notions of Pareto efficiency to Kaldor-Hicks efficiency, at least in contexts where private exchange and private ordering is feasible. One objection to the concept of Pareto efficiency, even in its own terms, is that concepts of voluntariness, complete information, and (absence of) externalities upon which it is predicated are extraordinarily vague and to an important extent indeterminate — a question I explore later in this essay.<sup>18</sup> A conventional external ethical critique of the concept of Pareto efficiency is that it takes existing preferences, of whatever kind, as given and provides no ethical criteria for disqualifying morally monstrous or self-destructive preferences as unworthy of recognition. This is a standard objection to any form of utilitarianism. Furthermore, it is also argued that Pareto efficiency is wholly insensitive to the justice or injustice of the prior distribution of endowments that parties bring to an exchange, but rather takes these endowments as given in evaluating the welfare implications of a given exchange, although it should be noted that Paretianism is not inconsistent with redistribution of prior endowments justified on some independent normative principle. The claim as to the centrality of individual autonomy as a central social value has been strongly contested by many scholars who see the autonomous individual self of classical liberal theory as reflecting an impoverished, atomistic, pre-social conception of human life.<sup>19</sup> Rather, it is constitutive attachments to particular families, communities, groups, and institutions which make human life rich and formative of true human identities. Moreover, it is claimed that many preferences are socially constructed, and their existence and validity should not be viewed as prior or exogenous to the choices of social, economic, and legal systems which help shape them. This kind of communitarian perspective would contend for a much more affirmative conception of individual autonomy or freedom that does not merely imply freedom from restraints, but the availability of adequate opportunities and resources to all individuals to enable them to achieve full human flourishing as social beings. Some of these objections are also directed against the concept of Kaldor-Hicks efficiency: it accepts all existing preferences (at least those supported by dollars) as equally valid; and to the extent that cost-benefit analysis reflects only willingness-to-pay measures of value (rather than underlying utility functions, whether able to be supported by dollars or not), disparities in endowments will bias cost-benefit judgments in distributively unjust ways. Posner's argument<sup>20</sup> that Kaldor-Hicks efficiency (or wealth maximisation) is a superior ethical norm to utilitarianism, because it only validates those preferences supportable by resources which in most cases have been obtained by providing goods

<sup>17</sup> For example, M Kelman, *A Guide to Critical Legal Studies* (1987) chs 4 and 5.

<sup>18</sup> See *infra*, under the heading 'The Economic Perspective on Contract Law'.

<sup>19</sup> For example, M Sandel, *Liberalism and the Limits of Justice* (1982); C B Macpherson, *Democratic Theory* (1973) especially 'Elegant Tombstones: A Note on Friedman's Freedom' 143–56; T Nagel, 'Libertarianism Without Foundations' (1975) 85 *Yale LJ* 136 (review of Nozick); M Walzer, *Spheres of Justice* (1983).

<sup>20</sup> R Posner, *The Economics of Justice* (1981).

or services to others that presumably have enhanced the welfare of the latter, has proven highly contentious and for many critics unpersuasive, in part because endowments may reflect the luck of the genetic lottery or early family circumstances and not any morally defensible theory of desert.<sup>21</sup>

I acknowledge that these criticisms of normative economics have substantial force, but view them as revealing the partial nature of the claim on total wisdom that economics must confine itself to, as I elaborate in the conclusion to this essay.

I will now briefly explore some of the general properties of the economic perspective on law in two contexts: property rights and the law of contracts.

## THE ECONOMIC ROLE OF PROPERTY RIGHTS

### Introduction

The definition and specification of property rights is primarily the function of the law of property and to a lesser extent the law of torts (nuisance). The protection of property rights is principally the function of both tort law (nuisance, trespass, conversion, detinue) and the criminal law. Providing for the transferability of property rights is principally the function of the law of contracts.

In defining and specifying property rights, an economic perspective would seek definitions and specifications that internalise as fully as possible to a property rights holder all the costs and benefits associated with utilisation of the property rights in question. Failure to internalise costs may create negative externalities leading to over-utilisation of the resources in question from a social perspective. For example, a widget factory that pollutes the surrounding neighbourhood treats clean air as a free resource even though people in the neighbourhood place a positive value on it. By not including this social cost in the costs of production of widgets, the price of widgets does not reflect their true social costs and too many are demanded by consumers, too many are produced, and too much pollution is created. Failure to internalise benefits may create positive externalities, leading to under-utilisation of the resource in question from a social perspective. For example, if I plant corn on my farm but other people are allowed to help themselves to it when it is ripe, there is little or no incentive for me to utilise the land in this way. Similarly, if I spend considerable resources inventing a new product but others are able to copy my idea without making any such investments and without reimbursing me, I have little incentive to use my innovative talents in this fashion. Optimal resource allocation and utilisation requires that both divergences between private costs and social costs be minimised and that divergences between private benefits and social benefits also be minimised. Hence arguments for exclusivity in the definition of property rights. Assuming that property rights

<sup>21</sup> 'Symposium on Efficiency as a Legal Concern' (1980) 8 *Hofstra L Rev.*

have been defined and specified in ways that internalise costs and benefits from utilisation of a resource as fully as possible, the economic perspective on property rights would then focus on the importance of facilitating the transferability of these property rights so as to ensure that they end up in their highest valued social uses.<sup>22</sup> This is principally the function of the law of contracts and the exchange process, to which I will turn shortly.

The Prisoner's Dilemma and the Tragedy of Commons are two related paradigms that address the problems described in the previous paragraph.

### The Prisoner's Dilemma Problem

In tracing out the implications in various contexts of the economic perspective on property rights, a central conceptual building block is an understanding of the Prisoner's Dilemma problem.<sup>23</sup> In its original formulation, game theorists postulated the following kind of example: two suspects are taken into custody and separated in different rooms where they cannot communicate with each other. The prosecutor is certain that they are guilty of a specific crime eg armed robbery, but he does not have adequate evidence to ensure their conviction at trial. He points out to each prisoner in turn that each has two alternatives: to confess to the crime that the police are sure they have done, or not to confess. If they both do not confess, then the prosecutor states that he will charge them with a minor charge such as illegal possession of a firearm, and they both will receive a minor sentence eg one years imprisonment each. If they both confess to the major charge, they will be prosecuted, but the prosecutor will recommend less than the most severe sentence that he expects they will receive (eg eight years imprisonment each). However, if one confesses (ie turns State's evidence) and the other does not, then the confessor will receive lenient treatment (eg three months in prison) whereas the latter will receive the most severe sanction provided by the law (ie ten years in prison). The payoff matrix can be reduced to the following.<sup>24</sup>

Prisoner 1	Prisoner 2	
	Not Confess	Confess
Not Confess	1 year each	10 years for 1 and 3 months for 2
Confess	3 months for 1 and 10 years for 2	8 years each

Figure 3

<sup>22</sup> See generally on the economic role of property rights, Posner, *op cit* (fn 20) ch 3; for a critique of efficiency arguments for private property, see D Kennedy & F Michelman, 'Are Property and Contract Efficient?' (1980) 8 *Hofstra L Rev* 711.

<sup>23</sup> R D Luce & N Raiffa, *Games and Decisions* (1957) 94-7; R Axelrod, *The Evolution of Cooperation* (1984) 7-11.

<sup>24</sup> Luce & Raiffa, *op cit* (fn 23) 95.

Obviously, the *joint welfare maximising* solution available to the two prisoners is for neither to confess, and each to receive one year in prison. However, each faces the temptation to confess, on the assumption that the other will not confess, in order to receive the lightest sentence of three months in prison for turning State's evidence. If each reasons in this way, both may end up confessing and receiving eight years in prison each, which is the *joint welfare minimising* outcome amongst the various alternatives. In a range of contexts, game theorists predict that, while not inevitable, there will be strong tendencies for this outcome to be the one that emerges.

In the original formulation of the Prisoner's Dilemma problem the parties whose welfare is directly at stake are not able to communicate with each other. However, even in settings where communication is possible, there is still a significant risk that defection rather than cooperation strategies may dominate. In a property rights context, let us consider the following example:<sup>25</sup>



**Figure 4:** property rights in a state of nature

### *Property Rights in a State of Nature*

Let us assume that in this primitive pre-legal society where individuals and groups exist in a so-called state of nature, Tribe A grows corn in one valley and in a neighbouring valley Tribe B produces beef. Let us assume further that Tribe A's land is unsuitable for producing anything other than corn and Tribe B's land is unsuitable for producing anything other than beef. Let us assume further that members of Tribe A would prefer to vary their diet from time to time by eating beef as well as corn, and that similarly members of Tribe B would prefer some corn as well as beef. Thus, the question arises as to how transfers of corn from Tribe A to Tribe B and transfers of beef from Tribe B to Tribe A can be achieved. The two basic options are trade or theft. A cooperative strategy would clearly dictate trade, a defection strategy would entail theft. The question is, will a cooperative outcome emerge? Clearly, in the short run, members of each tribe face substantial incentives to engage in theft rather than trade in that with the former option transfers entail lower costs for the recipient than in the case of trade where something has to be given up as a *quid pro quo*. However, if members of both tribes reason similarly, the limiting outcome may entail each tribe engaging in predatory strategies, with members of the other tribe engaging in defensive strategies, and in the result no corn or beef any longer being produced as all the energies of both tribes

<sup>25</sup> D C Mueller, *Public Choice* (2nd ed 1989) 9–11.

become absorbed in predatory and counter-predatory activities. This exemplifies the application of the Prisoner's Dilemma to a property rights conflict, where there is some significant risk that the *joint welfare minimising* outcome may emerge.

By way of reducing the likelihood that this outcome will emerge, as a first move members of each of the two tribes would need to recognise the exclusive property rights held by the other tribe in their land and the produce therefrom. Even in a state of nature, given that parties often face the prospect of repeated interactions with each other, the Prisoner's Dilemma problem may solve itself, with recognition emerging over time that co-operation rather than defection is the *joint welfare maximising* strategy (although long-standing mutually destructive religious factionalism in countries like Northern Ireland raise important puzzles as to why co-operative outcomes have not evolved over time). However, in contemporary societies involving much larger numbers of people, and more impersonal and transient relations, solving the Prisoner's Dilemma problem may prove more daunting in many contexts, and the formal legal system may need to play a much more central role in preventing the externalisation of costs or benefits from resource ownership and utilisation.<sup>26</sup>

### The Tragedy of the Commons

In medieval England, in many villages, individual villagers or families traditionally had access to a commons for grazing their livestock. The historical evidence apparently suggests that these commons in some cases were over-utilised and permanently grazed-out.<sup>27</sup> Let us imagine the following situation:

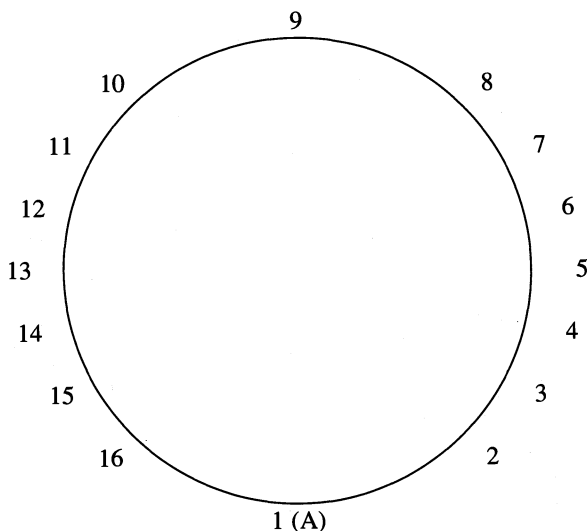


Figure 5

<sup>26</sup> *Id.*, ch 2.

<sup>27</sup> G Hardin 'The Tragedy of the Commons' (1968) 162 *Science* 1243.



An economic perspective on property rights would ask the following question: if each villager eg A, has unrestricted access to the commons, how will he or she go about deciding how many cattle to graze? The individual welfare maximising calculus would be to equate marginal private benefits and marginal private costs ( $MPB = MPC$ ). The marginal private benefits are presumably the milk or beef derived from grazing an additional cow. The marginal costs of raising another cow are presumably principally the pasture consumed, but here the marginal private costs are less than the marginal social costs, because Villager A bears only one sixteenth of the cost of the additional pasture consumed, and hence there is a wedge between marginal private costs and marginal social costs ie  $MPC < MSC$ . Obviously if each villager reasoned the same way as A, substantial over-grazing would result, and again the *joint welfare minimising* outcome may emerge. It is to be noted that if only one person owned the entire commons, this wedge between marginal private costs and marginal social costs would cease to exist, as the single owner would derive all the benefits from grazing the land but also would bear all the costs.

The problem of common property resources or common pools is pervasive in contemporary society. For example, most problems pertaining to the environment can be thought of as common pool problems, as can urban or highway congestion, or over-utilisation of beaches or parks, or crowding out of broadcast frequencies on the airways.

An interesting institutional exercise is to contemplate the range of possible solutions to the Tragedy of the Commons as originally formulated. These options might include the following: (a) the commons could be divided up into smaller and equal entitlements eg pie-shaped slices, with each villager entitled to a slice. This would internalise costs and benefits associated with ownership of the divided resource, but is likely to engender significant diseconomies of small scale (eg duplication of milking sheds, implements, fencing etc). It also treats efficient and inefficient farmers equally, and is unlikely to maximise total economic benefits from the land. Some of these inefficiencies could be minimised if the subsequent sale of initial entitlements were to be permitted; (b) a variant on the above would be to allocate to each villager a cow quota (eg four cows each) reflecting the long-term sustainable grazing burden on the land. Again, this may mute the problem, but it will not necessarily be the case that each of the villagers is an equally efficient farmer, so that maximisation of the total economic benefits from the land may not be achieved. Again, as in (a), subsequent sale of initial quota entitlements might be permitted so as to encourage the transfer of initial entitlements into the hands of higher valued users; (c) the entire block of land could be sold off to the highest bidder, who, as noted above, would face incentives to equate marginal benefits and marginal costs from the utilisation of the land in choosing how many cattle to graze on it. The highest bidder could then employ the other villagers. It may be objected to this solution that it is non-egalitarian and hierarchical and moreover will raise incentive problems in terms of whether villagers under employment contracts will face the same incentives to be productive as when their returns derive directly from the effort they put in; (d) the

villagers could incorporate a company or co-operative to own the resource, elect a board of directors, which in turn would appoint a manager to operate the resource on their collective behalves, buying cattle from villagers in return for shares in the corporation or co-operative and perhaps employing all or some of the villagers. This solution, at first sight, has some attractive properties in that the resource will be managed as a single entity, and hopefully marginal social benefits and marginal social costs will be fully equated. Also, it has more of an egalitarian appeal than a sale of the whole resource to a single highest bidder. On the other hand, questions would arise as to what incentives the manager would have to maximise total economic benefits from the resource as opposed to total personal perquisites, or simply shirking on the job. This is the classic agency cost problem confronted in many principal and agent settings,<sup>28</sup> and may pose significant problems in specifying and monitoring contractual arrangements with the agent. There is also a further serious problem as to whether a majority of shareholders (assuming majority rule) will always face incentives in electing a board and adopting collective policies that will maximise total economic benefits from the resource. There may well be a temptation to appropriate wealth from the minority for their own benefit (eg biased dividend policies etc). On the other hand, to attempt to solve these problems by a voting rule of unanimity may substitute tyranny of the minority for tyranny of the majority, where individual villagers face incentives to 'hold-out' for a disproportionate share of the benefits from collective resource management.<sup>29</sup> It should be noted that these problems would also have to be addressed in collectively choosing and operationalizing options (a), (b), and (c).

In confronting these problems of collective governance, there is a clear analogy to democratic politics more generally. In choosing voting regimes, and accountability mechanisms to contain agency cost problems, the original Prisoner's Dilemma and Tragedy of the Commons problems are unlikely to be perfectly solved, with incentives for rent seeking by coalitions of voters or interest groups, and incentives for agents of the voters (eg politicians or bureaucrats) to maximise the personal returns from office rather than collective returns.<sup>30</sup> Thus, many features of corporate law in the private sector and constitutional and administrative law in the public sector can be seen as attempts to address these collective action problems.

### The Pervasiveness of Property Rights Issues

Property rights issues are pervasive in both contemporary and traditional societies. It has already been noted that most environmental problems and other related problems, such as that of endangered species like whales or elephants can be seen as exemplifying classic Prisoner's Dilemma and common pool problems; similarly, in the case of natural resource exploitation such as

<sup>28</sup> For example, M Jensen and W Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *J of Financial Economics* 305; E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *J Pol Ec* 288.

<sup>29</sup> Mueller, op cit (fn 25) ch 3.

<sup>30</sup> Mueller, op cit (fn 25); M Trebilcock, D Hartle, D Dewees & R Prichard, *The Choice of Governing Instrument* (1982).

fisheries and forests. In the intellectual property sphere, debates over commercial piracy, compulsory licensing of patented drugs and other innovations, unilateral copying of texts and articles, reverse engineering, copying of computer software and hardware etc, all raise property rights issues that exhibit many of the central characteristics of the Prisoner's Dilemma and Tragedy of the Commons paradigm. With respect to interests in land, in response to increasing population density in urban and vacation centres, new interests in land have evolved, such as condominiums, co-operatives, and time-sharing arrangements where the incentive effects associated with different definitions of individual and common areas affect how the resources are utilised. In many developing countries, problems of land reform are central to the formulation of effective development strategies. The land reform problems assume sharply different complexions from one developing country to another. Sometimes the problem takes the form of gross aggregations of land holdings in the hands of a few absentee landlords. In other countries, there has been severe fragmentation of land holdings through traditional regimes of succession leading to substantial diseconomies of small scale. And yet in other countries, like Papua New Guinea, most of the land is owned communally by traditional tribes or clans who must make decisions as to land use on a collective (unanimous) basis, and often face severe legal constraints on formal alienability.<sup>31</sup> In the former command economies of Eastern Europe privatising state-owned property and enterprises is widely seen as essential to the more efficient utilisation of these assets, although the modalities of privatization have raised many complexities. In all of these contexts, an economic perspective on property rights is indispensable in uncovering the various incentive or disincentive effects associated with alternative legal regimes.

## THE ECONOMIC PERSPECTIVE ON CONTRACT LAW

### The Economic Functions of Contract Law

As noted above, neo-classical economists have a predilection in favour of resource allocation through voluntary exchanges as opposed to collective decisions because they believe that one can have a higher degree of confidence in the welfare implications of private exchanges, where both parties stand to benefit, than collective decisions where typically there are both winners and losers and it is difficult to net out gains against losses. However, this predilection for the private exchange or market process in the allocation of resources does not speak to the economic role of contract law. From an economic perspective, at least four major functions of contract law can be identified.<sup>32</sup>

<sup>31</sup> M Trebilcock, 'Communal Property Rights: The Papua New Guinean Experience' (1984) 34 *University of Toronto LJ* 377.

<sup>32</sup> A Kronman and R Posner, *The Economics of Contract Law* (1979) ch 1; for a critique of efficiency arguments for freedom of contract, see Kennedy and Michelman, *op cit* (fn 22).

### *Containing Opportunism in Non-Simultaneous Exchanges*

Let us return to the earlier example of Tribe A producing corn and Tribe B producing beef. Even if a stable regime of property rights is established so that members of Tribe A and members of Tribe B agree to respect the property rights of the other tribe, this in itself does not ensure that mutual gains from trade will be realised. In other words, we have ruled out theft but we have not yet facilitated exchange. Suppose that Tribe A's corn is ripe now and must be eaten within a few days and that Tribe A is prepared to trade a quantity of this corn for a calf from Tribe B, but that the calf will not be ready for delivery for another six weeks. If Tribe A delivers the corn today against the promise of delivery of the calf in six weeks time, there is a serious risk of defection by Tribe B when it comes time to meet its delivery obligations. Tribe A, perceiving this risk, may be disinclined to deliver the corn. In this event, the potential for a Pareto superior exchange would not be realised. This is a variant of the Prisoner's Dilemma problem. While in traditional societies conventions may develop that mitigate the problem, in contemporary societies the law of contracts, by providing remedies in the event of breach of contractual promises, provides an essential check on opportunism in non-simultaneous exchanges by ensuring that the first mover, in terms of performance, does not run the risk of defection rather than co-operation, by the second mover.<sup>33</sup>

### *Reducing Transaction Costs*

A second economic function of the law of contracts is to supply parties to given categories of exchanges with standard sets of implied terms (that typically they are free to bargain around if they wish) but which in most cases are joint welfare maximising and save the parties the transaction costs entailed in fully specifying a complete contingent claims contract.<sup>34</sup> In addition to various aspects of the common law of contracts, many statutes such as the *Sale of Goods Act*, the *Partnership Act*, and perhaps certain aspects of corporation statutes can be thought of in these terms.

### *Discouraging Carelessness in the Exchange Process*

A third economic objective served by the law of contracts is to discourage carelessness in the exchange process, causing detrimental reliance. Thus, in rules relating to breach of express warranties, innocent or negligent misrepresentation, mistake, promissory estoppel etc, the law attempts to assign liability for negative outcomes from an exchange to the party who could have avoided the problem by taking cost-justified precautions.

<sup>33</sup> A Kronman, 'Contract Law and the State of Nature' (1985) 5 *J of Law Ecs & Org* 1.

<sup>34</sup> J Coleman, 'A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law' (1989) 12 *Harvard J of Law and Public Policy* 639.

### Identifying Pareto Superior Exchanges

A central economic role of contract law is to formulate a set of excuses for contract performance that permits the enforcement of efficient exchanges, but discourages the enforcement of inefficient exchanges that do not meet the criterion of Pareto efficiency. It will be recalled that this criterion requires that at least one party to an exchange perceive himself or herself as better off and the other party no worse off, but in practice both parties, at least *ex ante*, should perceive the exchange as mutually beneficial. Within a Paretian framework, lack of voluntariness, imperfect information, or externalities are likely to provide the principal foundations for an economically grounded set of excuses, whatever the legal form that these may take. I want to explore briefly the challenges presented in specifying more precisely the conditions for a Pareto superior exchange.<sup>35</sup>

### Conditions for a Pareto Superior Exchange

A statement by Milton Friedman in *Capitalism and Freedom*, which would be widely endorsed by most neo-classical economists, provides a useful reference point in exploring these conditions:

The possibility of co-ordination through voluntary co-operation rests on the elementary — yet frequently denied — proposition that both parties to an economic transaction benefit from it, *provided the transaction is bilaterally voluntary and informed*.<sup>36</sup>

I believe that economists seriously underestimate the problems of specifying the normative content in many elements of the above proposition. Let me illustrate the analytical challenges which must be confronted.

### Commodification

Even if one shares the predilection for private exchanges over collective resource allocation decisions, this does not address the question of the limits on the domain of the private exchange process. As Arrow has pointed out, a private property private exchange system depends, for its stability, on the system being non-universal.<sup>37</sup> For example, if political, bureaucratic, regulatory, judicial, or law enforcement offices were auctioned off to the highest bidder, or police officers, bureaucrats, regulators, or judges could be freely bribed in individual cases, a system of private property and private exchange would be massively destabilised. On the other hand, one cannot assume that all these public officials will be saints and give endlessly of their time and energy and hopefully wisdom without some attention being given to appropriate remuneration and other incentive arrangements for them. The extent to which a healthy private sector presupposes the existence of a public sector,

<sup>35</sup> See more generally, M Trebilcock, *The Limits of Freedom of Contract* (1995).

<sup>36</sup> M Friedman, *op cit* (fn 14) 13 (his italics).

<sup>37</sup> K Arrow, 'Gifts and Exchanges' (1972) 1 *Philosophy and Public Affairs* 342.

and the design of incentive structures in the public sector that are complementary to the existence of a healthy private sector, are issues which have been insufficiently explored in much of the standard economics literature. A second dimension of the commodification issue is the question of whether certain human attributes should lie beyond the exchange process; is it inconsistent with theories of personhood and human flourishing to permit sale of sexual services, the sale of newborns, surrogacy contracts, participation in the production or sale or viewing of pornographic material etc?<sup>38</sup> As noted earlier in this essay, in reviewing the major limitations of the economic perspective Paretianism provides little purchase on which preferences should be recognised or validated. Again, these issues have often been largely assumed away by many economists.

### *Voluntariness*

As Friedman acknowledges, for exchanges to possess the mutually beneficial quality that is widely claimed for them, some degree of voluntariness in entering into such exchanges must be present. However, voluntariness is an elusive and complex concept. In a world where scarcity confronts all of us, few of us have unconstrained choices in any exchange relationship into which we enter. While some cases are easy, such as another party seizing my hand and forcing me to sign a contract, or a mugger inducing me to hand over money by confronting me with the alternative of my money or my life, where clearly in both cases I am rendered worse off as a result of my encounter with the other party, other cases are much more problematic.<sup>39</sup> For example, a solitary tug taking a foundering ship in tow in a storm in return for an agreed but extortionate salvage fee may well have entered into a Pareto superior exchange with the captain of the foundering ship, in the sense that both of them are made better off by the exchange relative to the situation that would likely have prevailed in the absence of any interaction between them. However, it seems appropriate to regard the tug captain's behaviour as reflecting the exploitation of a situational monopoly in which a disproportionate share of the gains from the exchange have been engrossed by the monopolist. But, in order to sustain this 'gouging' objection to the exchange, we are hard pressed not to rely on some theory of distributive justice or equality in exchange that goes beyond the bare notion of Pareto superiority. If we are prepared to relieve the captain of the foundering ship from the extortionate salvage fee, we must then confront difficult problems in other contexts. For example, if I happen to have come across a rare stamp (eg a Penny Black) in my recently deceased great-aunt's attic, and an obsessive stamp collector needs the stamp desperately to complete a particular collection, is it equally objectionable for me to demand

<sup>38</sup> M Radin, 'Market Inalienability' (1987) 100 *Harvard L Rev* 1849; Radin, *Contested Commodities* (1996); J Boyd White, 'Economics and Law: Two Cultures in Tension' (1981) 54 *Tennessee L Rev* 161. Contrast N Duxbury, 'Do Markets Degrade?' (1996) 59 *MLR* 331.

<sup>39</sup> A Kronman, 'Contract Law and Distributive Justice' (1980) 89 *Yale LJ* 472.

a very high price for this scarce resource?<sup>40</sup> Similarly, in the case of rare paintings which may be sold at art auctions for astronomical prices. If it is argued that the rare stamp or rare painting cases are different from the foundering ship case, because only in the latter case has advantage been taken of a life threatening situation, how can we then explain the sweep of our antitrust laws, which for the most part address problems of monopolisation or market power in non life threatening contexts? The explanation in these contexts, from an economic perspective, conventionally shifts from distributional effects to allocational effects and their impact on consumer welfare in terms of consumers who have been priced out of the market through reductions in output. But these concerns do not implicate the welfare of immediate contracting parties who remain in the market. Should we not equally be concerned about them if they are victims of 'gouging'? But if so, why not the buyer of the Penny Black, unless one argues that in this case there are no allocative effects associated with the 'gouging', because there is only one item to allocate, and output cannot be varied in order to inflate the price. If 'gouging' is to be permitted in the Penny Black case, but not the salvage case, one requires a theory of human personhood that makes opportunistic behaviour more objectionable where physical integrity is at stake rather than mere property.

Or, to take another example, is it objectionable for an exceptionally talented movie star or a professional sports star to 'exploit' his or her fans by charging very large fees for his or her services? To take yet a further example, suppose a single mother with six children living in impoverished circumstances, finds that food supplies for the family have run out a week before she receives her next welfare cheque and approaches a local food store operator and asks him to provide her with food on credit to see her through the week until she receives her next welfare cheque. On the assumption that the food store operator is not a monopolist but one of several food store operators in the area and is charging competitive prices, is it inappropriate for him to enforce this contract against her when through intervening misfortune she is unable to pay for the food from her next welfare cheque?

### *Asymmetric Information*<sup>41</sup>

As with voluntariness, the issue of imperfect information is pervasive in the contracting process. Almost no exchange is entered into with absolutely perfect information by both parties. Even the purchase of the morning newspaper from the local variety store on the assumption that it will contain an interesting film or restaurant review, when this assumption turns out to be false, reflects an exchange entered into with incomplete information. As with the voluntariness condition, some cases are easy. If, in selling a used car to you, I deliberately turn back the odometer prior to the sale in order to defraud you, clearly this is not a Pareto superior exchange if the car turns out to be worth half the contract price when its true mileage is revealed. However, other cases of deliberate non-disclosure are much more problematic. Let me list briefly

<sup>40</sup> C Fried, *Contract as Promise* (1981) ch 7.

<sup>41</sup> A Duggan, M Bryan and F Hanks, *Contractual Non-Disclosure* (1994).

some examples. First, take non-disclosure by sellers. In one case, an owner of a house discovers that he has termites in the attic as a result of hearing their activities at night or observing their droppings and that they have done serious damage to the structure of the house. He sweeps up the droppings in order to conceal their presence and only permits inspections of the house during the daytime so that the termites cannot be heard engaged in their activities at night. This seems tantamount to fraud and is unlikely to lead to a Pareto superior transaction, in which both parties are better off. On the other hand, if I advertise a used car for sale through the classified section of the local newspaper, am I under an obligation to point out every rattle, oil leak, whining noise or rust spot in the car to every prospective purchaser in order for a contract to be binding? But suppose I move it to a new parking spot so that a prospective buyer will not notice an oil patch on the driveway underneath the engine? Or, to take two examples involving non-disclosure by buyers. First, a prospective buyer observes a very rare first edition of Adam Smith's *Wealth of Nations*, personally autographed by Adam Smith (in his invisible hand), on sale for fifty cents in a carton of books being sold on a neighbourhood front lawn at a garage sale. Is the prospective buyer under an obligation to disclose the dramatic undervaluation of the book to the seller before buying it at the stipulated price? Similarly, if a prospector, through research of various kinds including flying over vast expanses of farmland taking magnetic soundings, forms a well-informed hunch that a particular block of farmland may have serious potential as an oil drilling sight, is he under an obligation to disclose this fact to the incumbent farmer before purchasing the land at a price that reflects only agricultural uses?

### *Externalities*

Friedman accepts as a limiting example of involuntariness the case of externalities or neighbourhood effects. To the extent that a contract between two parties entails negative externalities for a third party, one cannot assume that the exchange is Pareto superior once one takes account of the negative third party effects. Again some cases are easy. If A enters into a contract with B to act as hit man in killing or maiming a rival of A's (C), we would have little difficulty in viewing this exchange as failing to meet the criteria for Pareto superiority. In reaching this judgment, we would not be particularly concerned about balancing the costs imposed on the third party against the gains to A and B, because C's rights have been non-consensually violated. However, other cases are much more problematic. In a case where A manufactures and sells widgets to B, and in the process of manufacture inflicts pollution on a range of third parties in the neighbourhood, the contract between A and B is not Pareto superior given the costs imposed on the third parties (A and B are made better off, but the third parties are made worse off), but we may still want to balance the costs to the third parties against the gains to A and B, or alternatively the relative avoidance or abatement costs confronting the third parties on the one hand and A on the other (essentially a cost-benefit or Kaldor-Hicks efficiency calculus). Or suppose that I enter into a contract to



buy a bright red tie from a local men's wear store, but the tie drives you crazy because it reminds you of the repression your great-grandfather suffered at the hands of the Bolsheviks in pre-revolutionary Russia. Is this third party effect sufficient to negate the mutual gains from exchange realised by me and the men's wear store? Or if contracts for the rental of pornographic movies have the effect of reinforcing negative gender stereotypes about the role of women in society, are these third party effects sufficiently germane to negate whatever mutual benefits are derived by the parties supplying and viewing these videos? However, if we take this view, suppose that Jerry Falwell and the Moral Majority take the view that cohabitation outside of marriage is immoral and that contracts between landlords and tenants that facilitate such arrangements should be prohibited. Should the disutility perhaps genuinely sustained by Falwell and his followers by virtue of being members of a community where these allegedly immoral relationships occur be given any weight in evaluating the welfare effects of the tenancy agreements in question?

### *Gratuitous Promises*

In the passage from Milton Friedman quoted above, promises or commitments made in the course of 'economic transactions', because of their supposedly mutually beneficial qualities, appear to be singled out for specially privileged legal recognition. However, suppose that I, as a fully autonomous moral agent, declare, in all seriousness, before a large class of my students and in response to their entreaties, that I am committing myself to making a donation of \$1000 a year for five years to Greenpeace to further the organisation's environmental objectives, should I then be able to revoke this promise, even though Greenpeace has not paid for it in an 'economic transaction' and even though it may have not relied upon it in any tangible way prior to my revocation of it? In other words, why should promises have to be *paid for* in order to be viewed as binding?<sup>42</sup>

Through these various examples, I have attempted to show that while economists' general predilection in favour of voluntary exchanges as opposed to collective decision-making in the resource allocation process may well be justified, many of the complexities associated with specifying precisely what conditions must be met in order for an exchange to possess welfare enhancing qualities are often naively assumed away. Here, it seems to me that many lawyers have a much better measure than many economists of the complexities that have to be resolved.

<sup>42</sup> For an insightful review and critique of competing theories as to why and when promises should be binding and the choice of default rules for incompletely specified promises, see R Craswell, 'Contract Law, Default Rules, and the Philosophy of Promising' (1989) 88 *Michigan L Rev* 489.

## A BRIEF SURVEY OF OTHER AREAS OF ECONOMIC ANALYSIS OF LAW<sup>43</sup>

### Tort Law<sup>44</sup>

Much United States law and economics scholarship has focused on modelling alternative liability rules in areas such as product liability and medical malpractice, with a view to identifying a set of rules which is efficient in the sense of minimising the sum of expected accident and accident avoidance costs. This body of scholarship has largely focused on the debate between strict liability and negligence and on the kinds of defenses (eg contributory negligence, comparative negligence and *volenti*) that ought to be recognised under any liability regime. In addition, some attention has been paid to rules governing the quantum of damages, and in particular whether there is a case for awarding non-pecuniary damages. With respect to damages calculations more generally in torts cases, especially personal injury cases, economists are now quite widely used as expert witnesses in both the US and Canada in estimating expected economic losses from an accident, and applying appropriate discount rates to reduce future economic losses to a present value lump sum. The liability insurance crisis that hit North America in 1986, characterised by dramatic increases in premiums, reductions in coverage or increases in deductibles and exceptions, and in some cases withdrawal of coverage altogether, precipitated fundamental re-evaluations of what goals the tort system should properly be asked to serve in particular, whether viewing it as a risk-spreading or social insurance mechanism as opposed to a deterrence or corrective justice mechanism, in part explained the destabilisation of liability insurance markets, especially in the products liability and medical malpractice fields. Related debates have focused on the case for substitution of no-fault compensation schemes for the tort system, especially in the automobile accident context, where attention has often centred on the potential loss of deterrence incentives for avoiding risky driving behaviour. In general, in North America there has been little support for a general accident compensation scheme along the lines of the New Zealand Accident Compensation Scheme, in part because of its projected costs and concerns over the scale of likely *ex ante* and *ex post* moral hazard incentives for injurers and victims.

<sup>43</sup> For general reviews of law and economics, see R Posner, *op cit* (fn 3); R Cooter & T Ulen, *Law and Economics* (2nd ed, 1977); A Dnes, *The Economics of Law* (1996).

<sup>44</sup> S Shavell, *Economic Analysis of Accident Law* (1987); W Landes and R Posner, *The Economic Structure of Tort Law* (1987); D Dewees, D Duff & M Trebilcock, *Exploring the Domain of Accident Law: Taking the Facts Seriously* (1996).

## Corporate Law<sup>45</sup>

Over the last decade, legal and economic scholarship in the corporate law area has burgeoned and this area is currently one of the most active area in legal and economic scholarship. A wide range of issues has attracted attention, including the theory of the firm, and why we observe some firms contracting-out the supply of inputs, and in other cases integrating their production within the firm. Transaction cost economics and agency costs theory have also focused on alternative modes of organisation of the firm, as well the contracting out issue, by evaluating how alternative modes of legal organisation of productive activities may minimise various kinds of costs, such as information costs, monitoring costs, chiselling costs, and other forms of opportunism. Another body of scholarship has focused on the economic case for limited liability, and has raised serious questions as to whether, in some circumstances, limited liability permits firms inefficiently to externalise various kinds of costs of their activities to third parties. Another debate has surrounded the regulation of takeovers; what forms of defensive tactics incumbent management should be permitted to utilise and whether acquirers should be required to leave their bids open for some minimum period of time so that other bidders may have an opportunity to bid for the control of the target firm. Other issues that have attracted analysis pertain to the nature of corporate constitutions. One view that has attracted much support (although contested in various respects) is that corporate charters or constitutions should be viewed as a nexus of contracts amongst the various stakeholders in the corporation, the implication being that the role of corporate law is simply to supply a set of implied terms to the parties, including fiduciary duties and duties of care, which they should in most circumstances be free to reject or modify as they wish. With respect to the regulation of securities markets, much work has been done, both theoretical and empirical, on the strength of the efficient capital market hypothesis, and whether much securities market regulation, which is often predicated on serious information failures, can in fact be justified. Another emerging set of issues which has begun to attract the interest of legal and economic scholars relates to the privatisation of state-owned enterprises in Eastern Europe, where alternative models of the privatisation process clearly have very different efficiency and distributional implications.

## Competition Law

While competition or antitrust law is often viewed as one of the 'old' areas of law and economics, economic analysis has had a major impact, over the last two decades, on the evolution of North American competition law.<sup>46</sup> Two areas of competition law, in particular, have been fundamentally reconsidered as a result of new economic thinking. First, the highly mechanistic

<sup>45</sup> See generally, F Easterbrook & D Fischel, *The Economic Structure of Corporate Law* (1991).

<sup>46</sup> F Mathewson, M Trebilcock & M Walker (eds), *The Law and Economics of Competition Policy* (1990).

structural rules that focus predominantly on market share or concentration levels which dominated US merger law through the 1950's and 1960's (reflected in notorious decisions like *US v Von's Grocery Co*<sup>47</sup>), have now largely been rejected in favour of a more dynamic and less static framework of analysis that assigns central significance to factors such as barriers to entry and potential competition, including competition from foreign suppliers. The other area of competition law that has been fundamentally reconsidered involves vertical restraints, such as exclusive dealing arrangements, tying agreements and resale price maintenance, which previous economic thinking and legal doctrine viewed, with few exceptions, as anti-competitive. The current economic thinking, reflected increasingly in changes in legal doctrine, now views many of these arrangements as presumptively efficient and benign, and rather than being efforts by up-stream manufacturers to tie-up downstream markets and abuse market power, these arrangements can often be thought of as attempts to align the incentives of down-stream parties with up-stream suppliers in terms of inducing an efficient level of promotional and service effort by the down-stream parties.

### International Trade Law

International trade law has attracted increasing attention from legal and economic scholars, with scholarship focusing on the rationales for and design of trade remedy law regimes, such as anti-dumping laws, countervailing duty laws, and safeguards regimes.<sup>48</sup> The bulk of the scholarship has tended to converge on the view that anti-dumping regimes have no coherent economic rationale and that countervailing duty regimes have little more economic justification. Given burgeoning political discourse, particularly in the US, over fair trade rather than free trade, and the alleged virtues of level playing fields under threat of unilateral sanctions, including retaliatory action under Super 301 of the US *Omnibus Trade and Competitiveness Act* of 1988, legal and economic scholarship has much to contribute in sorting out specious (and self-serving) from well-founded 'unfair' trade claims. Another issue that has engaged attention relates to the rise of regional trading blocs and their relationship with the GATT WTO Multilateral System. To what extent do regional trading blocs involve trade diversion rather than trade expansion and how best can their relationship with other regional trading blocs and with the GATT WTO system at large be reconciled?

### Criminal Law

While the criminal law area has attracted less attention from legal and economic scholars than many other areas, some important work has been done, especially with respect to the determination of the optimal penalty for various kinds of crimes, especially white-collar crimes such as price fixing and securities fraud. Much of the literature has found significant elements of

<sup>47</sup> *US v Von's Grocery Co* (1966) 384 US 270.

<sup>48</sup> M Trebilcock and R Howse, *The Regulation of International Trade* (1996).

under-deterrence in the conventional penalty structure through failure to set the expected penalty, which is a product of the probability of apprehension and the punishment, at a level which removes any gains from engaging in the offending conduct. The literature has also modelled theoretically, and tested empirically, whether in setting the optimal penalty it is better to raise the punishment and lower the apprehension rate, or vice versa. Another area relates to the efficacy of criminal sanctions and alternative accident reduction regimes in the traffic accident context.<sup>49</sup> Most of the empirical literature finds here that conventional criminal sanctions have quite modest deterrence effects, while exposure limiting regimes appear to be much more effective. In a recent study that I and a colleague undertook for the Alberta Automobile Insurance Board, an analysis of a random sample of 577 physical injury claims files in 1990 revealed that 10 claims out of the total sample (1.7% of the claims) accounted for almost 40 percent of the total payouts. On closer examination of these ten claims, it turned out that nine of the ten defendants were males, six were young males aged 17 to 24, five involved alcohol impairment and seven of the accidents occurred not on city streets but on rural roads or highways. Exposure-limiting strategies would focus on policy options such as raising the drinking age, raising the driving age, wider use of short-term licence suspension, graduated licensing regimes where young drivers are subject to a curfew or subject to constraints as to who may accompany them in the car, or where even low blood alcohol levels or demerit points trigger licence suspension.

### Family Law

In family law, various economic theories of marriage have been advanced, some focusing on the gains from division of labour and specialisation, others on marriage law as a signalling device as to what kinds of relationships prospective marriage partners are seeking. In the light of these theories, assessments have been made of the likely impact of no-fault divorce reform on propensities to marry and behaviour during the marital relationship. An important related issue that has recently begun to engage Canadian courts and policy-makers is the determination of appropriate support obligations on marriage break-down, particularly in more traditional marriages where one spouse (typically the wife) is economically largely dependent on her husband and where as a result of marriage her ability to re-enter the workforce and earn a decent income for herself has been seriously impaired. Legal and economic scholarship has attempted to construct implicit insurance contracts that rational parties might agree to *ex ante*, to compensate for the economic consequences of marriage break down in these circumstances and to address the opportunity costs of marriage for the dependent spouse.

<sup>49</sup> M Friedland, M Trebilcock & K Roach, *Regulating Traffic Safety* (1990).

### Access to Justice

A good deal of legal and economic scholarship has addressed issues such as: (a) reasons for court delay and the modification of incentive structures for litigants and their lawyers to reduce these delays; (b) the case for contingent fees as a means of financing litigation; (c) the role of class actions as a way of achieving economies of scale in litigation; (d) the role of lawyers' advertising, both in alerting citizens to the need for legal services in various contexts and in terms of competing down fee levels; (e) the role of para-professionals in the delivery of legal services and possible forms of firm organisation that provide para-professionals with an ownership stake in law firms; (f) the role of pre-paid legal service plans.

### The Organisation of Law Firms

Some legal and economic scholarship has attempted to explain the economic rationale for a wave of local mergers amongst law firms, the growth of national and international law firms, and the emergence of multi-disciplinary law firms offering a broad range of professional services and involving co-ownership arrangements among lawyers and non-lawyers.

### Immigration Law

Recent legal and economic scholarship has focused on various aspects of immigration law that determine the total intake of immigrants and the composition of the intake in terms of whether the restrictions typically involved have any efficiency justifications for them. Some of this work has been of a detailed empirical nature, and has tended to refute many of the myths surrounding immigration, ie that immigrants displace existing citizens from jobs or depress their wages.<sup>50</sup> Most of this work would support a more liberal immigration policy not only for philosophical reasons, but even for more parochial efficiency reasons.

This is but a small sampling of areas in which legal and economic scholars have been active and a sketch of the kinds of issues and orientations reflected in their work. Many other areas have also attracted attention, such as constitutional law, eg problems of measuring discrimination under constitutional guarantees of equality, and the protection of the internal economic union in federal systems; commercial transactions, such as sales transactions and bankruptcy law;<sup>51</sup> intellectual property and the appropriate design of patent, copyright, and trademark rules; public choice theory, which is concerned with the implications of the design of alternative electoral systems and the regimes governing incentive structures in bureaucracies which are likely to shape their performance.

<sup>50</sup> J Simon, *The Economic Consequences of Immigration* (1989); G Borjas, *Friends or Strangers: The Impact of Immigrants on the U.S. Economy* (1990); Economic Council of Canada, *Economic and Social Impacts of Immigration* (1991).

<sup>51</sup> T Jackson, *The Logic and Limits of Bankruptcy Law* (1986).

## COMPARATIVE ALLOCATIVE SYSTEMS: THE CASE OF SCARCE LIFESAVING TECHNOLOGY<sup>52</sup>

In making contemporary societal choices amongst alternative mechanisms for the allocation of scarce resources, it is important to appreciate the basic array of systemic choices available and the economic, distributional, and other characteristics of each, so that choices are not made in the abstract, but relative to the alternatives. I use the case of scarce life-saving technology to illustrate these points.

The scenario envisaged here is one where in the early period of some new lifesaving technology, eg dialysis machines, too few units of the technology are available to meet existing demand. For example, let us assume that immediately after the invention of the dialysis machine, in any given jurisdiction there are ten machines available and 100 patients with serious kidney problems who face shortened life expectancy if they do not obtain access to a machine. Because supply is assumed initially to be fixed and the consequences so serious for those who do not obtain access to the scarce resource, Calabresi and Bobbitt characterise this type of case as a 'tragic choice'.<sup>53</sup> The possible modes of allocation and the strengths and weaknesses of each can be briefly summarised as follows:

### Markets

Here, as with other resources in a market economy, we could allocate the scarce resources to the highest bidders. Conventional economic analysis would assume that they place the highest value on them. Of course, the obvious objection to this regime is that people who may derive a disproportionately enhanced life expectancy from access to the technology, or who may value the resources very highly but cannot validate their valuations with personal resources, will not be able to bid successfully, including people who may claim that their past or prospective social contributions render them especially meritorious. One line of defence of the market regime in this context is that to the extent that there is a concern about the justice of prior endowments, this should be rectified separately and generally, and not through attempts to redress distributive justice concerns through the manipulation of the allocation of this particular scarce resource. For example, if prior endowments have been generally redistributed so as to comport with some defensible theory of distributive justice, would it any longer follow that a market form of allocation here would be objectionable on grounds of distributive justice? In any event, the question would have to be faced as to why this particular scarce resource should be viewed differently from a host of other scarce resources such as automobiles, housing, food, and clothing. What specifically makes the allocation of this particular scarce resource more 'tragic' than the others? If the answer is that this allocative decision bears on

<sup>52</sup> The discussion of this example is largely derived from G Calabresi and P Bobbitt, *Tragic Choices* (1978).

<sup>53</sup> *Ibid.*

issues of life and death, it might equally be argued that access to less rather than more risky occupations, to better rather than worse quality housing and food etc, also bear on the matter of life expectancy. Finally, in favour of the market, it may plausibly be argued that it is the one mechanism, of all of those to be reviewed, where the incentives created on the supply side from a bidding mechanism are likely to increase supply of the scarce resources over time, as the initial scarcity engenders further innovation and new entry into the production of the scarce resource or close substitutes for it. In other words, this mode of distribution of the scarce resource in itself will affect the future allocation of resources to its production (unlike the allocational mechanisms that follow).

### Lotteries

The ten dialysis machines in the above example could be allocated by putting the names of the 100 patients into a hat and allocating machines to the first ten names drawn out of the hat. This regime would have the virtue of being a randomised form of allocation which is wealth neutral. It is also presumably very cheap to administer. On the other hand, it will be insensitive to various claims of merit or desert that the 100 patients may wish to make in establishing priorities for themselves. There would also be a question of whether a secondary market should be permitted after the initial lottery, whereby winners in the lottery would be permitted to auction off their entitlements to the highest bidders. One might well argue that such a secondary market should be permitted, in that to the extent that a holder of an initial entitlement values expenditures on other purposes as preferable to some extension of life expectancy though access to the machine, society should not interfere with that preference.

### Queuing (First Come First Served)

Like a lottery, a queue is likely to be wealth neutral, and depending on how it is organised, may even favour those with low opportunity costs who can afford to invest a good deal of their time establishing and maintaining a high position in the queue. However, again as with lotteries, this method of allocation will be insensitive to various claims as to merit or desert that patients in the pool may feel should influence priorities in the allocation of the machines. As with lotteries, there would also be a question of whether a secondary market should be permitted.

### Voting Regimes (Democratic Allocation)

While many variants of a voting regime might be devised, one could imagine a regime where the 100 claimants to the machine constitute themselves a political assembly and decide the allocation collectively through democratic means. However, this assembly could not proceed directly to a vote, or each person would simply vote for themselves and there would be no collective decision. First, the assembly would have to decide (unanimously?) on a



constitution that would govern how decisions would be made. Perhaps the decision-rule adopted might entail each claimant presenting the merits of his or her claim to other members of the assembly, and each claimant would then vote for ten claimants (perhaps excluding herself or himself). The top ten vote getters would receive the machines. A number of questions would be raised by such a regime. How would ties be resolved? Would side-payments for votes be permitted (allowing wealth effects to intrude)? Could groups (parties) form to run slates? How stable would these coalitions be? In the light of Arrow's well-known impossibility theorem,<sup>54</sup> would collective outcomes that emerge reflect any coherent aggregation or ranking of individual preferences? In other words, would the collective outcomes that emerge reflect *anybody's* preferences? Would any set of rankings command stable majority support or simply engender voting cycles?<sup>55</sup> Even if individual preferences are rejected as the basic reference point, in favour of some communitarian theory of the good, such a theory must identify and justify (a) a substantive theory of the good and (b) some person or institution empowered to apply that theory and make the requisite allocations. Both tasks present formidable difficulties<sup>56</sup> as exemplified in the discussion that follows on merit allocation mechanisms.

#### Administrative (Merit) Allocation

Various forms of merit-based criteria could plausibly be chosen for application in an administrative allocation regime. These criteria are likely to have different implications for institutional design of the regime. For example, the criterion chosen might be a quantitative one of simply maximising Patient Life Years (PLY). Here one assumes that a group of medical experts are best able to decide which of the ten patients in the pool of 100 are likely to increase their life expectancies most through access to the dialysis machines. However, it may be objected that this criterion may pick up patients whose past or prospective social contributions are minimal or negative, eg habitual criminals, rapists, child abusers, or winos. In order to address this problem, one could choose instead a criterion of merit that focuses on future social contributions. Which ten patients in the pool of 100 are likely, in various ways, to most enhance the quality of life of the society of which they are members? Here, the problem will obviously be that these contributions will be of very different kinds and will not be readily commensurable, once one has rejected, as one would have done if the market form of allocation had been rejected, a metric of future social contributions that simply reflects what society is prepared to pay different people for different kinds of contributions. Moreover, in terms of institutional design, it seems obvious that medical experts have no particular comparative advantage in making these social valuations, but now the composition of the committee or agency which is to make the choices would become of critical importance. What would be the criteria for

<sup>54</sup> K Arrow, *Social Choice and Individual Values* (1951, rev ed 1963).

<sup>55</sup> Mueller, op cit (fn 25) ch 20.

<sup>56</sup> For an extended critique of communitarianism, see S Macedo, *Liberal Virtues* (1990).

membership on such a committee or agency and who would make the appointments? Or, alternatively, would one simply randomise the composition of the committee or agency through a ballot, eg by picking the names of 12 citizens out of a hat to constitute the adjudicative body (by analogy to a jury)? In terms of process, what kinds of information or submissions would the agency solicit from the 100 claimants and against what criteria would the information be evaluated; how would the veracity of the information be tested; should wealth differentials be neutralised in terms of resources employed in making representations; should invasion of privacy be a concern; would a reasoned set of decisions be required; would these decisions be subject to judicial review and against what criteria? Or should we adopt a completely non-rationalistic ('black box') rather than rationalistic decision-making process?

An alternative criterion to future social contributions would be past social contributions. That is to say, despite the fact that a claimant may be elderly and therefore likely to derive limited enhanced life-expectancy from access to a dialysis machine, and may be able to make only a minimal claim in terms of future social contributions, to the extent that this person has been a particularly valuable past contributor to the welfare of society, should this claim not be admitted (although, as in the case of future social contributions, difficulties of both substance and process would arise as to what would count as a more rather than less important past social contribution)?

Again, as with lotteries and queuing, under any system of administrative allocation the issue would arise of whether a secondary market should be permitted once initial entitlements have been determined. Moreover, the more general question would have to be faced that if we feel so confident of the robustness of the criteria for evaluating either prospective or past social contributions in this context, and for rejecting market valuations of either, why would we not wish to extend these criteria to all allocational decisions, including automobiles, housing, food, clothing, etc?

## CONCLUSIONS

In this brief review of the economic approach to law, I have sought to make several general points. First, it seems to me that positive economics, in predicting and testing the impact, allocative and distributive, of alternative legal regimes, offers powerful and indispensable insights about the implications of alternative policy choices. Positive economic analysis of legal doctrine, principally in transaction-oriented areas of the law, also offers useful, albeit qualified insights, into the structure and functions of legal rules. With respect to normative economics, the important distinction between Pareto efficiency and Kaldor-Hicks efficiency underscores the virtues of the private exchange or market process over collective methods of resource allocation in many contexts, although I have acknowledged the formidable conceptual problems that arise in specifying the conditions for Pareto superior exchanges. Even with respect to collective resource allocation decisions in contexts where the

private exchange process may not be feasible, it seems to me that the concept of Kaldor-Hicks efficiency, or at least its broader utilitarian precursor which is not dependent on ability to support preferences with dollars (but is correspondingly more difficult to measure), offers a useful discipline in analysing the choices that we must confront. In our daily lives, as individuals, as families, and as communities, given pervasive conditions of scarcity, we constantly face the need to choose amongst alternative good things: whether to read another law book or go out to a movie, whether to give money to one child to pursue university studies or to another child to go travelling, whether to build an opera house or provide enriched educational programmes for learning disabled children. None of these choices involves choosing between some things that are moral and others that are immoral, or some things that are good and others that are bad, but choosing between things all of which are, in an abstract sense, good. In making these choices, some form of cost-benefit analysis, however fragile and imperfect, seems unavoidable. Either Kaldor-Hicks efficiency or a broader utilitarian calculus forces us to confront the full opportunity costs of our choices.

While generalising about differences between US and non-US legal and economic scholarship is a perilous exercise, four tentative differences might be conjectured. First, the thesis of wealth maximisation (essentially Kaldor-Hicks efficiency) as an over riding ethical goal that has been espoused by Posner has won few adherents amongst legal and economic scholars outside the US. Second, the general thesis of the efficiency of the common law has also won few adherents in the US and even fewer elsewhere, and much scholarship has been devoted to critiquing various areas of the common law from an economic perspective. Third, many non-US scholars tend to be more agnostic about alternative policy goals than their US counterparts and instead of debating the wisdom of these goals have focused on ways in which they might be realised more efficiently.<sup>57</sup> Redistributing wealth from rich to poor raises important issues of technical or target efficiency in achieving the distributive goals at least cost and with minimum negative spill-overs. Even a Marxist who is committed to radical wealth redistribution, and who proposes a doubling of the corporate income tax rate to this end, should want to inform himself or herself about how the tax is likely to be shifted backwards to shareholders or employees or forward to consumers, what kinds of individuals comprise these groups, and whether corporate exit will be induced, thus negating any benefits to the proposed beneficiaries. Even running a non-profit public university or community day-care centre entails technical or productive (as opposed to allocative) efficiency issues in organising its operations effectively. Fourth, economic analysis of law has clearly exerted a much less central influence on contemporary legal scholarship and judicial decision-making in jurisdictions outside the US. While it is tempting to ascribe this differential influence primarily to ideological differences between the US and other societies, I believe that a more convincing explanation lies in the more recent and more tenuous hold that most forms of legal theory, eg feminist theory, constitutional theory,

<sup>57</sup> R Posner, *op cit* (fn 20).

legal philosophy, Critical Legal Studies, have established in other common law (principally Commonwealth) legal systems. It would be a serious misconception to view economic analysis of law as ideologically *sui generis* to the US. Issues of choice under conditions of scarcity are endemic to the human condition.

Let me conclude by acknowledging that any one-value view of the world is likely to prove, at the limit, self-defeating. For economists to claim that they are only interested in maximising the total value of social resources, without being concerned about how gains in the value of social resources are to be distributed and whether these gains are in fact making the lives of individuals better, and whose lives,<sup>58</sup> or while ignoring the impact of economic change on the lives of individuals or on the integrity or viability of long-standing communities, reflects a highly impoverished view of the world.<sup>59</sup> On the other hand, theorists committed only to concepts of distributive justice, who proceed in their analysis by inviting us to assume a given stock of wealth, or a given increase in the stock of wealth, and then asking what a just distribution of that wealth might entail, are largely engaging in idle chatter as long as the wealth creation function is simply assumed. Creating wealth is a necessary pre-condition to distributing it. Similarly, communitarians who stress values of solidarity and interconnectedness and discount values of individual autonomy and freedom risk pushing this perspective to an extreme where communitarian values become exclusionary, authoritarian, or repressive. Thus, that any one perspective on the world should offer only a fragmentary grasp on the total wisdom required to shape a more congenial world should not be surprising and should not be viewed as a fatal indictment of that perspective. I feel confident in asserting that in building a better world according to any sensible set of rights, an economic perspective will be an indispensable, albeit non-exclusive ingredient. The dramatic political and economic transformation of Eastern Europe which we are witnessing, the ethnic factionalism that is now renting many of these countries, and the tragic denouement of the student protests in China underscore how easy it is for us to take for granted the central role that competitive politics and competitive markets play in our lives in fostering growth, innovation, accountability, and individual freedom and initiative.<sup>60</sup>

<sup>58</sup> A Sen, *On Ethics and Economics* (1987).

<sup>59</sup> M Trebilcock, M Chandler & R Howse, *Trade and Transitions* (1990) ch 1.

<sup>60</sup> For example, F Fukuyama, "The End of History?" and commentaries thereon, F Fukuyama *The National Interest* (1989); F Fukuyama, *The End of History and the Last Man* (1991).