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The Past, Present, and Future of Law and Economics

George A. Hay

For the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics.

—— Oliver Wendell Holmes (1897)

ANY discussion about law and economics ought to begin with a definition or at least an explanation of what it is we are talking about. There is, however, a risk in starting there. Just as classics scholars may debate endlessly about who precisely should be counted as a classicist or philosophers might debate who can properly be counted as a Kantian, there is likely to be no consensus about precisely what counts as law and economics or who is doing it. Indeed, the acknowledged superstar and chief guru of the law and economics movement, Judge Richard Posner, has argued that, for centuries, judges, guided by 'an invisible hand', have unwittingly been deciding common law cases 'as though' they were applying economic principles (Posner, 1992:chs 18, 19). So, as The Honourable Sir Anthony Mason observed in his Monash Law School Foundation Lecture in 1992, some of the distinguished judges in the audience tonight, just like M. Jourdain in Molière's *Le Bourgeois Gentilhomme* who discovered that he had been speaking prose all his life, may deserve at least honorable mention on the list of who is 'doing' law and economics (Mason, 1991).

In order to avoid major controversy at the outset, I will define the law and economics movement simply as the conscious application of economic principles to problems arising in connection with the resolution of legal issues, recognising that this definition is too general to be of much help in deciding what gets counted and what does not. The significance of the word 'conscious' is simply to exclude all of the judges who, in Posner's view, at least, have been doing God's work by accident rather than design. In this article, I discuss the past, the present, and the future of the movement and report on some efforts to assess the impact it has had to date. Most of my material concerns the law and economics movement in the United

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States, where it began and where it has had the greatest impact. It is my hope that a review of the US experience will provide some sense of the potential that exists for the Australian Centre for Law and Economics and its members and followers to shape the future of law and legal scholarship in Australia.

The Past

When and where did the modern law and economics movement begin? The answer to that question is a bit tricky and depends on whether we include economic analysis of antitrust issues. One can hardly ignore the application of economics to antitrust, since economics has clearly been the dominant theme in the analysis of antitrust issues for much of the century and remains so today. One need only examine a few recent decisions by the US Supreme Court to find not only that references to sophisticated economic writing pervade the footnotes, but also that the analysis has spilled over into the text as well.[1] And closer to home (in a cultural, if not geographical, sense), the Privy Council's recent decision in the celebrated *Clear* case is based on the most modern and sophisticated economic principles (although this is not necessarily to say that the Court got them right).[2]

Given that antitrust is fundamentally about economics, and that the statutes, certainly in the US but to a large extent in Australia and New Zealand as well, are written in language that virtually requires economic analysis, the early use of economics to analyse these kinds of cases is hardly surprising. But to link the law and economics movement to antitrust distorts somewhat our attempt to place the movement in a meaningful historical context, since it was not until much later that economic analysis was used in a significant and influential way to address classic 'legal' issues arising under the common law — issues arising in property, contracts, and torts, for example.

Hence, if the goal is to date the emergence of economic analysis to a broad range of legal issues, the key time frame is 1960-61, which marks the appearance of Ronald Coase's (1960) classic, 'The Problem of Social Cost'[3] and Guido Calabresi's first (though not most well known) writing on torts, 'Some Thoughts on Risk Distribution and the Law of Torts' (1961). It is also worth noting that the first volume of *The Journal of Law & Economics* appeared in 1958. The first several volumes contained mostly articles on antitrust-related issues. It was really only after Coase took over the editorship in 1964 that the *Journal* began to publish articles concerned with the economic analysis of strictly 'legal' problems,[4] although, even so, the focus remained on problems associated with antitrust and traditional economic regulation.

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[1] See for example *Eastman Kodak Co. v Image Technical Services Inc.* 112 S. Ct. 2072 (1992).

[2] *Telecom Corp. of New Zealand, Ltd. v Clear Communications Ltd.* [Judicial Committee of the Privy Council on Appeal from the Court of Appeal of New Zealand, 19 October 1994].

[3] In 1991 Coase won the Nobel Prize in Economics primarily for this and his earlier article, 'The Nature of the Firm' (Coase, 1937).

[4] For example, Demsetz (1964, 1966); Dunham (1965); Crecine et al. (1967).

The next key events occurred in 1971-73 and mark the emergence of Richard Posner as the intellectual pied piper of the law and economics movement. Posner's first major contribution was to establish *The Journal of Legal Studies* in 1972. Whether or not there was an official 'allocation of territories' between *The Journal of Law & Economics* and *The Journal of Legal Studies*, it was the latter that provided the main forum for the application of economic principles to 'traditional' legal problems. A glance at the first few volumes reveals a number of classic articles in this genre.[5]

It is useful in this context to recall a portion of Posner's editorial on the goals of the new journal.

> The aim of the *Journal* is to encourage the application of scientific methods to the study of the legal system. . . What can a journal do to encourage the scientific study of law? First, it can provide a place of publication for, and so encourage the production of, research too technical for the tastes of law review editors and readers. The use of mathematical and statistical methods is a pervasive characteristic of modern science, natural or social. It is bound to be a feature of a mature field of scientific legal studies.
>
> Second, a journal can provide a meeting ground for scholars unfamiliar with parallel work being done by other scholars trained in different disciplines from their own. Lawyers write about the legal system in law journals, economists write about the legal system in economic journals, sociologists in sociological journals, and so on. But the law journals are read almost exclusively by other lawyers, the economic journals almost exclusively by other economists, and the sociological journals almost exclusively by other sociologists. The result is that the research of the different disciplines, although it is directed to the same problems, does not converge.
>
> Third, a journal, through its editorial decisions and policies, can help create a sense of identity in a new field. It can define the areas of research that seem central, and by implication those that are peripheral. It can establish standards of rigor and accuracy. It can help to forge a common language for expressing the results of research. (Posner, 1972b:437)

But if Posner's new journal was to be the vehicle for much of the early 'scientific' work in law and economics, it was the publication in 1973 of Posner's book *Economic Analysis of Law* that demonstrated to potential law and economics scholars the vast opportunities for scholarly research in the area. If ever a work deserves the title 'seminal', it is surely this one. Each chapter dealt with a specific branch of the law (such as contracts), and each section within the chapter took a specific issue from that branch (such as specific performance) and demonstrated,

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[5] Demsetz (1972); Posner (1972a); Ehrlich (1972); Barton (1972); Landes (1973); Epstein (1973); Brown (1973).

admittedly in a relatively superficial way, how economics could shed light on the way the law had evolved to deal with that issue.

Posner built his economic analysis of law on what he calls the three fundamental principles of economics: that the higher the price the less individuals will want to consume (the 'law' of downward sloping demand); that individuals seek to maximise their utility and firms seek to maximise their profits; and that resources tend to gravitate to their most valuable uses if voluntary exchange — a market — is permitted (Posner, 1992:3-13). Using these three principles, Posner showed how one can explain or, at least, rationalise a long list of common law doctrines especially in the area of property, contract, and tort law.[6] So, for example, in his chapter on property law, Posner explains why in the eastern part of the United States, where water is plentiful, the basic rule is that riparian owners are each entitled to make reasonable use of the water, provided that use does not interfere unduly with the rights of other riparians. In the western states, where water is scarce, exclusive rights can be obtained by appropriation (pp.36-7). In the same chapter he explains why the basic rule for abandoned property, like a shipwreck, is finders keepers, although the common law sometimes gives the first committed searcher for abandoned property a right to prevent others from searching so long as his search is conscientiously pursued (p.37). In his chapter on contract law, Posner uses economics to explain the general principle that contract modifications are unenforceable without fresh consideration but also uses economics to explain some of the exceptions to that principle (p.98). That chapter also contains an elegant discussion of the economic basis for the doctrines of duress and unconscionability (pp.110-17). And in his chapter on tort law, he uses economics to explain why, as a general matter, compliance with custom is not a defence in a tort action, but why there are exceptions, such as the area of medical malpractice (pp.168-9).

Posner's overall theme, in the book as well as in much of his subsequent writing, is that the common law has a tendency, for reasons later developed in more detail by others (Rubin, 1977), to evolve toward an economically efficient solution to a given problem; and most of Posner's examples were designed to show that tendency at work. But readers did not have to be persuaded of Posner's ultimate theme (and many were not) to see the power of economic thinking when applied to these kinds of problems. I am sure that, for many of the economists who read that first volume (certainly for me), the initial reaction was 'Wow! That's a neat way to think about a problem. How can I develop these ideas in greater detail? What other legal doctrines can I try to understand and explain by using economic analysis?'. The serious scholarly efforts were published in *The Journal of Legal Studies* or one of the other subsequent law and economics journals. But, for most of this work, Posner's book was the jumping-off point.

[6] Over the nearly 20-year interval between the first and fourth editions of the book, Posner has gradually expanded the collection of legal rules that he analyses through the lens of economics. The fourth edition contains material on family law, criminal law, employment law, civil and criminal procedure, and aspects of constitutional law such as the protection of privacy.

Another key event during this time frame, and one which has particular significance for this occasion, was the founding of the Law & Economics Center by Henry Manne and, in particular, his program of running an annual Economics Institute for Law Professors and a Law Institute for Economics Professors. The first of these Institutes was in 1971; they became firmly established when Manne set up shop at the University of Miami Law School in 1974. Most law professors now doing work in law and economics attended the Economics Institute early in their careers, and most economics professors working in the field attended the Law Institute. The Center also organised a series of Institutes for Federal Judges (The Economics Institute, The Quantitative Methods Institute, and The Corporate Governance and Financial Markets Institute). To date, more than 400 federal judges have participated. The key to the success and influence of these Institutes was that one did not need to have prior experience or even empathy with the law and economics movement to attend. Indeed, a main purpose was to expose law and economics to those who had not seen it before. Manne chose only the very best instructors; they were (and are) distinguished scholars; but, equally importantly, they had a proven ability to communicate their ideas to persons with little prior knowledge or experience in the area.

The final key historical development was the early effort to apply economics to corporate law and governance. The reason I attach special significance to this particular subset of the law and economics movement is that the application of economic analysis has transformed the entire face of this area of the law and led to its own sizeable literature. As Roberta Romano puts it in the introduction to her book of readings:

> Corporate law underwent a revolution over the past decade. In the midst of an extraordinary period of innovation in business organisation and acquisitive activity, legal scholarship was transformed by the use of the new analytical apparatus of the economics of organisation and modern corporate finance. This learning has already had, and will increasingly have, a profound impact on corporate practice and, accordingly, on the teaching of corporate law. (Romano, 1993:v)

The modern application of economic analysis to issues of corporate law and governance traces its roots to Ronald Coase's other classic article, 'The Nature of the Firm' (1937). Coase's article posed the question of why some forms of economic activity take place across markets, while other forms of economic activity take place within firms. The decision to organise activities across markets involves transactions costs. On the other hand, the decision to organise activities within firms involves agency costs. But while the modern literature builds on the fundamental insights of Coase that these costs are the primary determinant of how a firm organises its affairs, the relation between his original paper and the modern literature is far more distant than that between 'The Problem of Social Cost' and the modern scholarship on contracts, property, and tort law. The work that many

scholars would probably identify as the first major piece in the modern field is Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure' (1976). But the real credit probably belongs to two other members of the 'Chicago School,' Frank Easterbrook (another one of those moonlighting judges) and Daniel Fischel, who did much of the early work to develop this branch of the field.[7] I acknowledge also my colleague, Jonathan Macey, who, in the past ten years has contributed dozens of papers to the corporate law and economics literature (see for example Macey, 1993), while, here in Australia, Ian Ramsay has been turning out law and economics work on corporate law issues at a rapid pace (see for example Ramsay, 1994). These scholars have argued that an important goal of the law, according to the economic approach, is to reduce agency costs within the firm. The law does this by providing a model, 'standard form' contract, that investors and managers can use in order to reduce the transactions costs of contracting, and allowing the parties to alter these standard terms when the terms do not suit their individual needs.

The Present

Morton Horwitz wrote in 1980:

> I have the strong feeling that the economic analysis of law has 'peaked out' as the latest fad in legal scholarship and that it will soon be treated by the historians of legal thought like the writings of Lasswell and McDougal. Future legal historians will need to exercise their imaginations to figure out why so many people could have taken most of this stuff so seriously. (Horwitz, 1980:905)

Since then, Ronald Coase has won the Nobel Prize; Posner's *Economic Analysis of Law* is in its fourth edition; and the number of specialised journals devoted to law and economics has increased significantly. Every major law school has at least one economist or lawyer-economist as a member of its faculty, and most of the top schools have several. Each year produces several students graduating with JD/PhDs from the best schools, many of whom seek to enter law teaching. There is a new organisation, The American Law & Economics Association, with several hundred members, with an annual meeting that is very well attended.

The Law and Economics Center has moved to George Mason University Law School where its Director, Henry Manne, is also Dean. All students in the Law School are required to be familiar with economics and quantitative methods, and a good portion of the faculty would describe themselves as being a part of the law and economics movement. The Center continues its programs for law professors, economists, and federal judges.

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[7] Their earlier work has been nicely put together in a single volume, *The Economic Structure of Corporate Law* (1991).

There are several textbooks in Law and Economics suitable for undergraduate economics courses (I use Cooter and Ulen, 1988), and a few designed primarily for law students (such as Barnes and Stout, 1992; Goetz, 1983). There is at least a dozen series of working papers in law and economics, so that the latest scholarship can be traded without the usual publication lags. And, of course, there is a law and economics discussion group on the Internet. It is fair to say that the law and economics movement is alive and well and very active.

The Future

What of the future? Where will the law and economics movement be in 20 years, and what will have been its major accomplishments? What problems might arise? Let me suggest just a few possibilities.

Has the law and economics movement peaked? I do not think the law and economics movement has peaked, at least not if measured by the number of scholars involved at any given time, the amount of literature produced by those scholars, and the influence of that scholarship on the courts. There are at least a few very basic reasons for this.

First, law and economics is not just a fashion in legal analysis. A major part of the law and economics movement is simply the application of a kind of high-level common sense about the way individuals and firms respond to changes in prices and costs (although it took the genius of people like Richard Posner to show how powerful economic common sense could be in addressing legal issues). While not every opinion in a garden-variety tort or contract case will read like a Posner article, as long as 'the law' continues to try to guide the way individuals and firms behave, economic analysis will be relevant, indeed inevitable.

Second, serious scholars in many fields of law have no choice but to become familiar with the law and economics scholarship in their field if they are to be taken seriously. Regardless of whether one accepts all the teachings of law and economics in the corporate law area, for example, no serious scholar of the next generation can ignore that literature. As part of that process, some will become familiar enough with the law and economic approach to understand it but will reject it for a variety of possible reasons. Fair enough. But some portion of those who put a toe in the water out of necessity will become fully immersed and eventually contribute to the body of scholarship.

Third, the level of economic literacy among law students has increased substantially over the past 20 years. Hence, future generations of law students will be better equipped to bring economic analysis to bear from the very beginning of their law school careers.

Fourth, it is my impression that we are seeing many more joint degree candidates in law school, and upon graduation a substantial percentage of these JD/PhDs seek to enter academia. Hence, more will be equipped to do the kind of frontier work associated with people such as Professor Ian Ayres of Yale Law School (see Ayres & Gertner, 1992).

The costs and benefits of technical elegance. Despite my general optimism over the future of law and economics, and while one of the benefits of law and economics scholars who are fully trained in economics is technical elegance and work of a much higher level of sophistication, the eventual result of this trend may be to relegate genuine law and economics scholarship to a niche field.

One of the great attractions of the pioneer work in law and economics (such as Posner's book) was how much could (apparently) be done without a lot of technique. That book contained no equations more complicated than the Learned Hand formula for determining negligence. It was fun to read, and even those with only the most basic training in economics could understand it and felt they could contribute to it.

But compare Posner's book to any recent edition of *The Journal of Legal Studies,* or some of the important work by Steven Shavell on torts, for example (Shavell, 1987). If publication in peer-reviewed journals comes to require the level of mathematical/economic sophistication reflected in those works, the enthusiastic amateurs who made many of the early contributions and, perhaps more importantly, provide the bulk of the audience for those contributions, will be frozen out of the picture.

One can't really complain about this — you can't expect to do modern physics counting on your fingers — but it will, at the very least, result in a system in which the most sophisticated work will be done and read by only a tiny portion of the scholarly community. The academic payoff for trying to do the kind of intuitive scholarship made popular by Posner may become too low to warrant the effort. So what is likely to develop is a kind of two-track system such as that which now exists in industrial organisation — the branch of economics that deals with monopoly and competition and forms the basis for economic analysis in the antitrust area. The frontier scholarship is far too technical for general consumption, and it is left to a band of others — often economic-trained lawyers or economists with a law school affiliation — to translate that frontier work into a form that can be understood by courts, legislators, and practitioners. As is the case in the applied antitrust economics field, courts will have to come to understand that the policy relevance of the readable tier of the law and economics scholarship will be constrained by the simplifying assumptions that will be embodied in those distilled writings.

Empirical work. If the bad news is that the frontier theoretical work will be at too high a level of sophistication for the bulk of the scholarly community, the good news is that there is a rich opportunity for a different kind of scholarship, requiring fewer technical economic skills (but perhaps more in the way of computer literacy, imagination, and hard work). I am speaking of empirical work and the best examples of that work I can think of are being done at Cornell Law School by my colleague, Ted Eisenberg, with a growing set of co-authors, who have spent the past several years analysing various aspects of the outcomes of litigated cases. Here are some examples of their findings.

First, the 'conventional wisdom' is that in personal injury cases plaintiffs do better with juries than with judges. Yet, upon analysis, in several important areas of personal injury tort law, the mean award in cases tried before federal judges is higher than the mean award in cases tried before juries. This is so despite the fact that the amount demanded in the jury-tried cases was higher (Clermont & Eisenberg, 1992).

Second, in the 1980s to this day, much attention has been paid to a products liability crisis. Yet while the shouting was at its peak, plaintiffs' fortunes in products liability cases were in substantial decline. The raw number of (nonasbestos) products liability filings declined by about 40 per cent from 1985 to 1990 (Eisenberg & Henderson, 1992).

Third, several studies of appellate opinions show that Democratic judges are more liberal than Republican judges. The authors studied the mass of civil rights case filings, not the refined set of cases that reaches appeal. They found that the judges' backgrounds, as measured by political party or appointing president, did not provide useful information in forecasting the outcomes of civil rights cases (Ashenfelter, Eisenberg & Schwab, 1995).

Fourth. in death penalty cases, the authors showed (based on post-trial surveys of the jurors) that an important predictor of whether jurors would vote for life or death was how long they believed the defendant would remain in prison if they voted for life. The South Carolina Supreme Court refused to allow jurors to be told what a 'life' term actually meant, and jurors greatly underestimated the effect of a life sentence, assuming that most of those sentenced to 'life' were released for one reason or another after serving only a relatively short time. Those jurors that underestimated the most tended to vote for the death penalty. The US Supreme Court, which cited the study, held that jurors had to be told that life could mean a minimum of 30 years or even no possibility of parole (Eisenberg & Wells, 1993).

Many other empirical projects are planned or in progress. But clearly the most interesting and exciting development is the use of the World Wide Web to allow public access to and experimentation with the federal court's data base. Cornell's 'Judicial Statistical Inquiry Form' is available for all to use.[8] To illustrate the use of the Cornell data base, I inquired about antitrust cases in federal court that were fully tried and concluded during the period 1979-93 (regardless of when the case originated). I was interested in whether it mattered whether the case was tried to a jury or not. This is what I learned with approximately 30 seconds of very simple data commands on my part (the results came back within 30 seconds).

There were 1,019 fully tried cases during the period. Of those 389 were decided by a judge, the remaining 630 were tried to a jury. In cases tried to a jury, plaintiffs won 53 per cent of the time. In cases decided by a judge, plaintiffs won 39 per cent of the time. The average case took three years and four months from filing to conclusion and this did not differ significantly as between judge and jury cases. The mean judgment for plaintiff (averaged over all those cases in which there was a

[8] Internet address: http://teddy.law.cornell.edu:8090/questata.htm.

judgment for plaintiff) was US$1,785,450 in cases decided by a judge and US$1,652,736 in cases tried to a jury.

Conclusion

The law and economics movement has been the single most powerful intellectual movement in the history of legal education. One can reject it or embrace it; but one cannot ignore it. To its supporters, it presents an elegant and effective way of analysing and assessing legal doctrine in almost any branch of law. To its detractors, it represents an imperialistic telescope yet one with a distorting lens: seeking to scan the entire horizon, while highlighting certain values and completely overlooking others.

The fact that the law and economics movement has a considerable history, especially in the US, represents a major advantage to the founders and supporters of the Centre for Law and Economics in Australia. The Centre begins with considerable information about areas of research that are likely to be fruitful, educational programs that are likely to be successful, and the political and philosophical landmines that lay in the path ahead. But these advantages come at a price: that we expect nothing but splendid results.

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The complete text of Professor Hay's speech is available from the Centre for Law and Economics, Faculty of Law, The Australian National University, Canberra, ACT 0200, Australia.

The Centre for Law and Economics

THE Centre for Law and Economics was established in 1994 to serve as a focus for research into the law and economics of national law reform and decisions of Australian courts. Its founding Director is Dr Ian McEwin.

The Centre will be adopting some of the very successful ideas introduced by Henry Manne in the United States. Apart from the usual academic diet of seminars and conferences, short courses on important policy matters integrating law and economics perspectives will be run. Plans are being made to run courses in economics for Australian and New Zealand judges. An annual volume titled the *Australian Courts Economics Review* will be published, as well as a quarterly newsletter and a working paper series in law and economics.

The Centre will be self-funding and it is anticipated that it will employ several research staff and be a national centre for postgraduate training and scholarship in law and economics in Australia. Regular visits from law and economics scholars from other countries, particularly from the United States, will be encouraged.

The Centre has an Advisory Board consisting of a number of eminent Australians with an interest in law and economics. They are: Professor Bob Baxt, Partner, Arthur Robinson and Hedderwicks, Melbourne (formerly Dean of the Law and School at Monash University and Chairman of the Trade Practices Commission); Mr John Bowers, Managing Director, Frank Russell Australia Ltd; Professor Tom Campbell, Dean, Faculty of Law, ANU; Professor Geoffrey Brennan, Director of the Research School of Social Sciences, ANU; Professor Don Lamberton, ANU; The Hon. Mr Justice Santow, Supreme Court of NSW; Mr Richard St John, General Counsel, BHP Ltd; Professor Glenn Withers, Director, Economic Planning and Advisory Commission.

An International Advisory Committee has also been formed consisting of a number of prominent academics. They include Ronald Coase (Nobel Laureate from the University of Chicago Law School); Robert Cooter (Berkeley Law School and currently President of the American Law and Economics Association), Henry Manne (George Mason Law School); Roberta Romano (Yale Law School) and Susan Rose Ackerman (Yale Law School); Michael Trebilcock (Toronto Law School); and Cento Veljanovski (formerly of Oxford University, now CEO of Waverley International, Hong Kong).

An initial research agenda has been formulated. Funds will be sought for four research law and economics projects in the following areas: trade practices after Hilmer; corporations law reform; the regulation of financial instruments; and the relationship between law and economic development in East Asia. A project in the telecommunications law and economics area is also being considered.

If there is sufficient interest the Centre will also help to establish an Australian Law and Economics Association. For further information, contact Ian McEwin at the Faculty of Law, The Australian National University, Canberra ACT 0200, Australia; tel. (61) (0)6 249 3396, fax (61) (0)6 279 8335, e-mail ian.mcewin.@ anu.edu.au.