Introduction E490: Seminar on Economics and the Law

Traditionally capstone courses allow students to apply the skills and knowledge they have acquired while pursuing an undergraduate major. Applications can take the form of either quantitative or analytical analysis. In this course we will stress the analytical over the quantitative. This is not to suggest that quantitative is unimportant. It is most likely, however, that economic reasoning rather than quantitative analysis will play a more prominent role in your future career. Very few of our graduates become practicing economists, but almost all find that fundamental economic reasoning is a useful tool in whatever career they choose.

There is nothing truly unique about economics in the law as a topic for the senior seminar. This seminar could just as well have been about economics in sports or entertainment. The law is simply a backdrop for applying economic principles to a topic that is not normally considered conducive to economic analysis. The primary purpose of the class is to enhance your ability to engage in applied economic analysis. This course will provide you the opportunity of applying those economic skills you have acquired in the foundations courses. You will be required to analyze unique issues and express your analysis in both written and oral form. You will have a chance to test your understanding in a critical setting. The small class size should permit ample opportunity for you to defend and perfect your economic reasoning.

This is not a class in the law. We will assume certain legal precepts that may not reflect current legal realities. We will be concerned with how certain legal principles may enhance or diminish economic efficiency. Hopefully, economic analysis can help us understand why the law has evolved in certain ways, in much the same way that economics helps us understand the development of markets and prices.

The Four Areas of the Law to be Examined

In this class we will examine four main areas of the law: property, contracts, torts and criminal law. Economics plays a prominent role in each of these applications of the law. **Property law** has to do with the definition of property rights and the assignment of property rights. For a market system to function efficiently, it is essential that property rights be adequately defined. Market systems create efficiency in exchange. Exchange moves resources from lower value uses to higher value uses. The ability to engage in an exchange assumes a preexisting system of law and property rights. You can only enter into an exchange when the rights to the good being exchanged are clearly defined. For example, when the Soviet Union collapsed it was not clear who owned the material resources. Did the state own the rights to the land or were the rights to land vested in the laborers who had worked it? Until ownership rights were determined, resources could not be moved into their most productive uses.
Contract law is also essential for efficient market exchanges. Immediate exchanges that do not impose future obligations on the exchanging parties do not require contracts. Contracts involve deferred exchanges. They obligate the contracting parties to some future performance. We enter into contracts because we expect a mutually beneficial outcome. If each party performs as specified in the contract, both should benefit. Of course, expectations are not always realized. Things can change between when the promise of performance is made and when the performance is to occur. I may promise to deliver a particular good at a specified price in the future. The promised price will depend on my expected cost of production and delivery. Suppose those costs rise unexpectedly. If it is now unprofitable for me to deliver the product at the agreed upon price, I might decide to renege on the promise. If I breach the contract, the promisee may be entitled to some damages under the law. How are those damages to be determined? The decision to breach will depend on whether the loss given performance is less than the damages upon breach. Thus, the law may affect an economic decision that impacts the allocation of resources.

It is not always optimal for contracts to be honored. Forced performance may result in a waste of resources. For example, if you forced me to deliver parts that cost me $1.10 to produce when you could purchase these same parts from another seller that could produce them for $.90, this would move resources from a more highly valued use to a less valued use. This wastes resources that could be more productively employed elsewhere. Consequently, some breaches may enhance efficiency. A lot of contract law has to do with determining an optimal damage rule that produces efficient breaches.

A wrongful act that results in bodily or property damage to others is a tort. Tort law is similar to contract law in that it is also concerned with damages rules. However, with a tort it is either impossible or impractical for the related parties to contract for the allocation of potential damages. We will only be concerned with unintentional torts. I commit a tort when my actions somehow or other impose costs on you. Unintentional torts have to do with risky behaviors that have unintended consequences. Dick Cheney wanted to shoot fowl. However, his actions resulted in an unintended injury to his hunting partner and he is probably responsible for an unintentional tort.

We can avoid harming others by taking precautions. However, precautions are expensive and, therefore, must be weighed against potential damages. Damage rules in torts will determine both who takes precaution (the victim, the injury or both) and how much precaution is undertaken. Some damage rules can result in either too little precaution or too much precaution. There is too much precaution when the marginal cost of additional precaution exceeds the marginal benefit from additional precaution. An optimal damage rule will produce an optimal level of precaution where the marginal cost of precaution is just equal to the marginal benefit from precaution.

The course will conclude with a brief examination of criminal law. Rational criminals can be deterred by expected punishment. On the other hand, if we assume that criminals are irrational or that some acts, such as spousal homicide, are initiated by irrational emotions, then criminal behavior may not be affected by expected punishment.
Expected punishment will depend on the probability of apprehension and type of punishment. Consequently, an economic analysis of criminal law will attempt to balance the cost of additional criminal activity against the additional cost of deterrence. In an economic analysis, punishment serves as a deterrent. It is never pursued for its own sake. Nevertheless, it is in this area of the law that economic analysis is most likely to come into conflict with our moral precepts.

Since punishment incurs resources, the optimal punishment is just enough to deter the crime. The identical punishment for different crimes may leave the criminal indifferent between committing a crime and obeying the law. For example, if society imposed a death penalty for both robbery and murder, a criminal that committed robbery might just as well murder the victim. An optimal penalty would make the crime marginally unprofitable. Criminals, however, may gain non-pecuniary satisfaction from their crimes that may be difficult to value. Accordingly, generalized punishments that uniformly penalize criminals will not take into account individualized non-pecuniary benefits.

**Approaches to Law and Economics**

This course will be mainly concerned with an “economic approach to the law.” This means that we will emphasize the impact of laws on economic efficiency. We will be concerned only tangentially with questions of morals or ethics. This does not mean that questions of morals and ethics are unimportant. We eschew these concerns because they largely fall outside the realm of economic analysis. Academic economists generally try to avoid normative issues that lack objective standards. Accordingly, we should be wary about using economics to defend what is “right” or “just” in any normative sense. It is possible that the most efficient result may offend our sense of fairness or equality. We may decide to opt for the less efficient alternative in order to achieve some higher goal.

Francesco Parisi, in “Positive, Normative And Functional Schools In Law And Economics,” discusses how academics have approached the study of law and economics. He outlines two approaches, the **Chicago-style** and the **Yale-style**. The Chicago approach pioneered by Ronald Coase and Richard Posner posits the hypothesis that the common law has evolved in favor of efficient outcomes. This evolution occurs as courts revisit previous decisions that with hindsight have produced inefficient results and as courts modify the common law to fit changing circumstances. Inefficient decisions are most likely to be challenged in the courts, because they impose higher costs on the affected parties. Members of the Chicago school often find efficiency a desirable objective, but tend to avoid other normative judgments based on economic analysis.

The Yale school uses economics to reach normative conclusions on what the law ought to be. The analysis often is concerned with market failures and how the courts may correct those failures. Moreover, they argue that imperfections in legislation are not likely to be worse than imperfections in private markets. Economics provides a guide to the
most efficient path for attaining fairness and justice. However, the end-goal is never solely efficiency. Efficiency or wealth maximization should further some other social goal.

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