CRITICAL SURVEY

This is the third of a series of Critical Survey articles. The aim of the series is to report on recent developments, to provide an assessment of alternative and to suggest lines of future inquiry. It is intended that the articles will be accessible not only to other academic researchers but also to students and others more practically involved in the economy. Future Survey articles will include Warren Samuelson on ‘Institutional Economics’, Philip Arestis on ‘Post-Keynesian Economics’ and Geoffrey Ingham on ‘Economics and Sociology’.

Law and Economics in the United States: a brief historical survey†

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The discipline of Law and Economics is often seen as beginning in the late 1950s, with the founding of the Journal of Law and Economics, or perhaps in 1960 with the publication of Ronald Coase’s article ‘The Problem of Social Cost’. In fact, Law and Economics is much older and there was a significant Law and Economics movement during the Progressive Era (roughly 1890–1920). The movement since the 1960s is more neoclassical in character than the Progressive movement, which was strongly influenced by institutionalist economists. But even today Law and Economics makes many assumptions that are not well settled within neoclassical economics. For example, the most interesting and ubiquitous uses of the Coase Theorem occur in bilateral monopoly markets where economic efficiency cannot be proven on ordinarily neoclassical premises, and the brand of welfare economics used in much Law and Economics is hardly uncontroversial. Nonetheless, the modern Law and Economics movement is diverse in both subject matter and ideology and continues to be an exciting area of considerable intellectual controversy.

Introduction

Although not everyone agrees about the proper definition of ‘Law and Economics’, two seem to be helpful. First, Law and Economics is the study of the role of economics in the formation of legal policy. Second, Law and Economics is the study of law using the assumptions and methodologies of economics. Law and Economics is sometimes said to

†Editorial note. This article appears as part of this Journal’s series of surveys on current topics in economics. The title and scope of the survey derive from the predominantly North American origins of the modern law and economics movement. Students wishing to study the spread of interest in law and economics to the legal systems of other countries may wish to consult the symposium of articles on that subject in International Review of Law and Economics vol. 11 (1991).

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consist of a 'positive' branch and a 'normative' branch. The first is the use of economics to study the effects of actual legal rules; the second is the use of economics to determine optimal, or most efficient, legal rules. But to the extent that this terminology suggests that so-called 'positive' Law and Economics has only a minimal normative content, it is badly conceived here, just as it is in economics generally. As practised in the United States, most Law and Economics requires generalisations about utility and social welfare that are traditionally identified with neoclassical welfare economics. As such, the normative content is both substantial and inescapable, even for that branch of Law and Economics we think of as 'positive'.

Differences of definition bear heavily on one's view of the appropriate domain of Law and Economics. For example, Richard Posner describes the discipline as 'economic analysis of law', defined as the application of the methodologies of neoclassical economics to the study of legal rules (Posner, 1992). An important implication of this definition is that Law and Economics is limited to the study of those legal policy values to which neoclassical economics is relevant. For example, one might exclude from the domain of Law and Economics distributional concerns that arise in legal policy but are considered outside the boundaries of neoclassical economic inquiry. Under this view, Law and Economics has little or nothing to say about the optimal distribution of wealth, even though legal policy might be heavily involved with such questions.\(^1\) For example, Posner concludes that forcible wealth redistribution is 'in efficiency terms, a form of theft' whose 'justification must be sought in ethics rather than in economics' (Posner, 1992, at 461). An even stronger version of this definition is that the exclusive goal of legal policy is economic efficiency, and that legal policies that cannot be justified on efficiency grounds are somehow inferior or at least unscientific (Posner, 1981).

A broader view of Law and Economics opens with the premise that the legitimate domain of legal policy is wider than the domain of inquiry that neoclassical economics has defined for itself. As a result, Law and Economics is concerned not only with economic analysis of law as such, but also with the appropriate limits of economic analysis in legal policy making. To give one obvious example: neoclassical economics adopts a narrow and idiosyncratic measure of 'welfare' that does not even purport to consider how happy or generally well off people are; rather, it identifies welfare with willingness to pay. By contrast, the legal policy maker may use more catholic measures for determining economic well-being. These alternative measures may be drawn from psychology or the other social sciences, and may take non-utility information into account (e.g. Sen, 1982, p. 18; Sen, 1985, pp. 1771–1772). If economic analysis of law assumes that the only conception of welfare is the rather narrow economic one, it either has nothing to say about the use of non-utility information in legal policy, or else it concludes that such measures are somehow inferior to alternative measures of welfare.

But to be useful to the policy maker, Law and Economics must recognise both the legitimacy and necessity of alternative measures of well-being in policy analysis. From that point, a healthy perspective on Law and Economics must include an appreciation of the limits of neoclassical economics, and helpful inquiry into such questions as when the use of non-utility information is appropriate or when some form of interpersonal utility

\(^1\) Alternatively, Law and Economics can say something only about the efficiency effects of wealth transfer programmes. For example, one could do a cost-benefit analysis of such programmes, measuring their social cost in constant dollars. But one could say very little about the utility effects upon the payors and payees under such programmes without making interpersonal utility comparisons.
comparison is necessary, regardless of methodological difficulties. To date, very little scholarship in Law and Economics in the United States has inquired into these limits, and much remains to be done.

**Law and Economics before 1960**

Those engaged in Law and Economics today often write as if Law and Economics is a distinctly recent invention, originating perhaps with the publication of Ronald Coase's article on 'The Problem of Social Cost' in 1960 (Coase, 1960; with some credit given to Calabresi, 1961) or the founding of the *Journal of Law and Economics* at the University of Chicago in 1958. But this claim exaggerates the truth considerably. Law and Economics in the United States has a very long pedigree, stretching back at least as far as Daniel A. Raymond's *The Elements of Constitutional Law and of Political Economy*, first published in 1840.

Wide-ranging economic analysis of legal policy in the United States was first undertaken during the Progressive Era, when the marginalist revolution in economic thought inspired a great deal of interest by economists in various problems of legal policy (Hovenkamp, 1993A; Hovenkamp, 1990E). An important forerunner was Henry Carter Adams, whose classic essay on *The Relation of the State to Industrial Action* (1887) redefined regulatory policy toward the business firm by relating the degree of regulation that might be needed to the presence of economies of scale in the production process.3 A focal point of the debate between classical economists and emergent marginalism in the United States concerned the appropriate role of the state in making legal policy—the marginalists generally arguing for more intervention than the classicists were willing to tolerate (see Adams, 1886; Ely, 1884; Newcomb, 1884). For example, American Thomas N. Carver actually preceded F. Y. Edgeworth in the use of marginal utility theory to make a social welfare argument for the graduated income tax (Carver, 1895; Edgeworth, 1897). American economist Edwin R. A. Seligman became a prominent marginalist authority on Progressive income taxation, and was widely cited in American courts on questions of tax policy (Seligman, 1909; Seligman, 1894; see Hovenkamp, 1990E, pp. 1002–1005). The first comprehensive neoclassical analysis of the nature of the business firm was produced by Thorstein Veblen shortly after the turn of the century (Veblen, 1904; see also Veblen, 1923), and elaborated with great brilliance by his student John R. Commons in the 1920s (Commons, 1924). Progressive economists such as Richard T. Ely wrote large books on the relationship between contract and property law and the distribution of wealth in the United States, concluding that these areas required a larger measure of government regulation than the common law provided (e.g. Ely, 1914).

In sum, Law and Economics during the Progressive Era was robust, lively, and encompassed a range of inquiries including the common law as well as explicit welfare policy. However, its practitioners were distinguished from the Law and Economics of the 1960s and after in two respects, with the result that those in the latter group have largely

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1 For recent work on the possibility of interpersonal utility comparisons, see J. Elster and J. Roemer, 1991, and J. Elster and A. Hylland, 1986. By and large, this work has had little impact on Law and Economics in the United States.

2 For an interesting first-person account of the development of Law and Economics at the University of Chicago in the mid twentieth century, see Kitch, 1983.

shunted aside the contributions of those in the former. The first difference was that the former group, who were marginalists writing before the ordinalist revolution, believed that interpersonal comparisons of utilities were possible and justified broad-based policies of wealth redistribution. Indeed, much of their Law and Economics inquiry was directed toward this end. Second, Progressives engaged in Law and Economics were generally more interested in legislation than in common law rules, and tended to be fairly optimistic about the use of regulation to achieve goals in the public interest.

The impact of the welfare economics revolution of the 1930s and 1940s greatly dampened interest in Law and Economics for a time. Before ordinalism took hold, neoclassical economics contained a strong biological component, derived in part from other social sciences, that regarded the human being’s utility curve as a product of natural selection, and as relatively common across individuals (see Hodgson, 1992). This permitted economists to speak of ‘welfare’ in objective, fairly categorical terms, and enabled them to make interpersonal ‘utility’ comparisons of a sort. More importantly, this notion that human choice is driven by biological development gave economics a methodology in common with both the other social sciences, and also with the legislative policy maker, who generally measures welfare by objective rather than subjective criteria.

But ordinalism, particularly the work of Lionel Robbins, cut the knot between biology and utility (Robbins, 1932). Thereafter, the economists’ utility curve would be thought of as given, and any inquiry into its origin illegitimate—a viewpoint greatly encouraged by the rise of economic positivism in the 1950’s. From that point, the generally legislative, objective welfare concerns of the legal policy maker diverged sharply from the strictly market based concerns of neoclassical economics. The latter was thought to be valuable chiefly in areas of legal regulation of explicit markets—such as antitrust (competition) law or the law of economic regulation. By contrast, most legal policy makers retained their interest in welfare policy, but began to look to other social sciences than economics to provide the theoretical justifications. During this period, from roughly 1935 to the late 1950s, Law and Economics in the United States was not particularly exciting. Even the Legal Realists, who were famous for their use of the social sciences to examine legal rules, were generally oblivious of mainstream economics and did not regard it as central to their movement.

The impact of the Coase Theorem

No matter how one dates the revival of Law and Economics, much of the credit must be given to those in the law school and economics department of the University of Chicago. Indeed, in the eyes of some, Law and Economics is identified with the ‘Chicago School’. That conclusion exaggerates the truth, however, and there are as many practitioners who stand outside that school as within it. In brief, the Chicago School stands for an approach to Law and Economics that is rigorously neoclassical in the sense that it rests on strong assumptions of utility and profit maximisation, traditionally ordinalist, and positivistic in its methodology. Its approach is also highly analytic and quite anti-historical.

The new Law and Economics movement can be said to begin in 1960, with the publication of Ronald H. Coase’s ‘The Problem of Social Cost’. Indeed, some practitioners of the discipline deny that a field of Law and Economics even existed

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1 See Friedman, 1953. The method was suggested for economics in the 1930s by Lionel Robbins (see O’Brien, 1988, ch. 3). Friedman’s methodology was strongly influenced by the positivist critique of science generally. For example, Popper, 1935. See generally Blaug, 1976.
before. The best explanation for this position is that Coase's article divided the territory between the 'old' and the 'new' Law and Economics in much the same fashion that Robbins' Essay (1932) divided welfare economics into 'new' and 'old', by destroying the basis for interpersonal utility comparisons. Just as Robbins' work sharply reduced the domain of neoclassical welfare economics to the study of markets and Pareto optimality, Coase's work reduced the domain of Law and Economics to the study of the implications of the Coase Theorem for legal rule making. In the process, both revisions greatly reduced the perceived value of all that had gone before.

This was not what Coase intended. Coase's argument in 'The Problem of Social Cost' can be interpreted in both a neoclassical and an anti-neoclassical fashion. The former interpretation adopts the neoclassical approach of assuming a theoretical world of zero transaction costs (as neoclassical economics almost always has), emphasises that the Coase Theorem finds efficient results in such a world even if markets are not competitive in the neoclassical sense, and views transactions costs as 'imperfections' that explain why efficient results sometimes fail to occur.

By contrast, the anti-neoclassical interpretation, the one that Coase himself had in mind, sees the theorem fundamentally as an invitation to study the role of transaction costs. Coase himself believes that the study of transaction costs is overlooked in neoclassical economics, for the idea of such costs is fundamentally inconsistent with the supposedly 'rigorous' assumptions that neoclassical economics chooses to make about markets.

Coase himself is clear that legal systems exist and are worth studying only because of transaction costs:

If we move from a regime of zero transactions costs to one of positive transactions costs, what becomes immediately clear is the crucial importance of the legal system . . . I explained in 'The Problem of Social Cost' that what are traded on the market are not, as is often supposed by economists, physical entities but the rights to perform certain actions and the rights which individuals possess are established by the legal system. While we can imagine in the hypothetical world of zero transactions costs that the parties to an exchange would negotiate to change any provision of the law which prevents them from taking whatever steps are required to increase the value of production, in the real world of positive transactions costs, such a procedure would be extremely costly, and would make unprofitable, even where it was allowed, a great deal of such contracting around the law. Because of this, the rights which individuals possess, with their duties and privileges, will be, to a large extent, what the law determines. As a result, the legal system will have a profound effect on the working of the economic system and may in certain respect be said to control it. (Coase, 1991)

Speaking empirically, Coase concludes that 'it would not seem worthwhile to spend much time investigating the properties of [the zero transaction cost] world (Coase, 1988, p. 15); and '[t]he world of zero transaction costs has often been described as a Coasian world. Nothing could be further from the truth' (ibid., p. 174).

Under this second interpretation, the Coase Theorem is much less a normative argument for free markets than is popularly believed in the United States. Rather, Coase's essay recognises that all law, from the most elaborate regulatory regime down to the simplest common law rules, should be viewed as mechanisms for dealing with the problem of transaction costs. Thus we have Coase's own insistence (a) that institutions are important and (b) that they need to be studied individually, for the transaction costs inherent in one institutional setting cannot automatically be generalised to another. A minority of American scholars, led principally by Oliver Williamson, have taken this distinctly 'Coasian' view more seriously (e.g. Williamson, 1985, 1990).
The neoclassical interpretation of the Coase Theorem, which is clearly dominant in Law and Economics in the United States, sees its real brilliance in the analysis of disputes between two persons (or firms) over legal entitlements—precisely the kind of dispute that forms the setting for most common law adjudication. This connection between Law and Economics and the common law system of structuring legal rights cannot be exaggerated. Neoclassical Law and Economics generally believes that the institution of the common law, with its elaborate toleration of private settlements of disputes, is nothing more than a market.

In this model a dispute between adjoining land owners over, say, the losses that might result from trespassing cattle or flooding water creates a bargaining situation in which the two land owners are the only participants and the good to be sold or purchased is the entitlement to be free from the injury. Coase argued that in the absence of transaction costs, broadly defined, the two parties would negotiate a result that is both efficient and invariant to the underlying legal rule. This ‘invariance thesis’, stated simply, means that the bargained for production decision and outcome will be the same whichever party is assigned the initial liability.

For example, suppose that a farmer and a furniture manufacturer are neighbours. The furniture maker’s process generates a fine dust that settles on the farmer’s crops, ruining them. The value of continued production to the furniture maker is $100, while the value of crop production to the farmer is $80. In the jurisdiction at issue, the furniture maker’s pollution is enjoinable as a common law nuisance. The Coase Theorem predicts that the furniture maker and the farmer will strike a bargain under which the farmer abandons his cause of action and the furniture maker pays the farmer some amount between $80 and $100, thus making both better off. By contrast, if in this jurisdiction the dust-producing activity is not a nuisance, the farmer will be unwilling to pay the furniture maker more than $80 to abandon the activity, and the furniture maker will be unwilling to accept less than $100. In both cases (liability and nonliability) the result is that the furniture making continues. Further, this result is ‘efficient’ in two different senses. First, it is Pareto efficient since no alternative bargain can be struck. Second, it tends to maximise the joint wealth of the two parties.

The Coase Theorem was not written in an intellectual vacuum. Already in 1924 Frank H. Knight had argued that one of Pigou’s arguments for taxation of public goods was fallacious (Knight, 1924). Coase’s own previous article, The Federal Communications Commission, had stated a complete version of the Theorem, with both efficiency and invariance theses (Coase, 1959). Pigou had argued in his 1918 Economics of Welfare that the free market yields excessive use of certain facilities having upward-sloping cost curves (Pigou, 1918), although he removed the argument from later editions. For example, suppose there were a large, bumpy road sufficient to accommodate every truck at transport cost of $5.00, in delivering a $10.00 load. A second highway is much smoother, but also much narrower, and its cost of use increases with the density of traffic. The cost for operating one truck is $1.00; for two trucks it is $2.00 per truck; for three trucks it is $3.00 per truck, and so on. In the absence of any control, Pigou argued, the narrow road would end up having five trucks, operating at a cost of $5.00 each, since at that

1 Transaction costs must be defined broadly to cover externalities, or third party effects, and any impediments to bargaining that might result from the status of the participants as bilateral monopolists. Indeed, Coase later defined them so broadly as to imply that ‘transaction costs’ account for the traditional neoclassical view that outcomes in bilateral monopoly markets are indeterminate and perhaps inefficient. (Coase, ‘Notes on the Problem of Social Cost’, pp. 158–161 in Coase, 1988). Failures resulting from imperfect information are also generally regarded as transaction costs.
point the marginal cost of using the two roads would be equalised. But in that case, the full value of the narrow road would be lost, since all the trucks on that road could have used the wide road for $5.00 each as well. The optimal solution, three trucks on the narrow road, producing a social gain of $6.00, would come about only through taxation or licensing. Knight showed that the Pigouvian tax was necessary only on the assumption that the road was unowned. If it were owned by a private entrepreneur who charged a toll for its use, the toll would be set at a rate that produced the efficient number of trucks on the narrow road, since this would maximise the profits of the road’s owner.

Knight’s argument contains the germ of the ‘efficiency’ thesis of the Coase Theorem. If all the means of production are thought of as assigned to private parties, then there will be no externality problems and all allocations will be efficient. Coase’s two critical additions were that (a) the efficient result depends on the absence of transaction costs; and (b) the result will be invariant to the underlying legal rule, assuming that the legal right itself is an entitlement capable of being transferred. Finally, and perhaps most importantly, Coase emphasised that classical areas of the common law such as nuisance are best viewed economically, not as relationships between a wrongdoer (tortfeasor) and a victim, but rather as simple questions of incompatibility. In the case of the neighbouring farmer and furniture maker, the two uses cannot exist efficiently side-by-side, but that observation alone says nothing about who is wrong and who is the victim. Economically speaking, we should prefer the use that creates the largest net social value.

The neoclassical version of the Coase Theorem has many important implications for the economic analysis of legal rules (see, e.g. Polinsky, 1980; Regan, 1972; Cooter, 1982). Perhaps most importantly, if the goal of the law is allocative efficiency, then legal policy should do two things: first, it should leave the market to determine outcomes to the extent possible wherever the market seems to be functioning well. Second, the law should minimise the effects of transaction costs by selecting a rule that would approximate, as far as possible, the result of bargaining in a world without transaction costs (Demsetz, 1967). To put it another way, the most general effect of transaction costs is to preserve the status quo even when the status quo is inefficient; an efficient legal regime would therefore ensure that the status quo, or default, rule is the efficient outcome as much as possible.

Although neoclassical Law and Economics has invested heavily in the Coase Theorem, the Theorem itself is theoretically controversial, and cannot be justified under standard neoclassical assumptions. First, the Theorem assumes that bilateral monopoly markets for legal entitlements are efficient, just as competitive markets for commodities are. But the Coase Theorem is hardly a corollary of the First Welfare Theorem, and that Theorem does not apply to bilateral monopolies. Indeed, the literature exploring the relationship between the Coase Theorem and the First Welfare Theorem is embarrassingly thin (see Farrell, 1987). Within the neoclassical literature the given wisdom is that bilateral monopolies cannot be shown to be efficient and that they produce indeterminate results. Further, not only is the Coasian market a bilateral monopoly, it is also a market for a highly idiosyncratic product: namely, a legal entitlement as between two individuals or firms. Such entitlements are unique in that often their value cannot easily be determined by comparison with other markets, often they involve numerous ‘sunk’ or unrecoverable costs to the parties, and often there is considerable uncertainty about their existence and appropriate scope. To the extent legal rules are unclear, the ‘product’ being traded on

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1 For example, Samuelson, 1947. For a counter-argument, that bilateral monopolies do in fact produce efficient outcomes, see Blair, Kaserman and Romano, 1989.
these markets becomes somewhat ambiguous. Finally, at least some Coasian markets
seem to be unstable in the sense that they have no ‘core’, or equilibrium position in
which bargaining will predictably come to rest. This observation has been noted
several times, but its fullest implications have not been explored (Aivazian and Callen,
1981). Other Coasian markets may have great difficulty achieving equilibrium even when
they technically speaking have a core. For example, the polluting factory surrounded by
100 home owners must purchase the right to pollute from all; so there must be
unanimous consent respecting a series of contracts where the division of the surplus is
indeterminate and each party may stand to benefit from further bargaining for a larger
share (Hovenkamp, 1992). The neoclassical interpreters of Coase (but not Coase
himself) generally assume all these problems away by classifying them as ‘transaction
costs’.

The invariance thesis of the Coase Theorem is also subject to dispute, if one takes
either income effects or individual declining marginal utility of income into account.
Under either assumption it is quite easy to devise a problem in which the outcome of a
legal rule will determine the result. For example, suppose the polluting furniture factory
is adjacent to a house, and the homeowner experiences declining marginal utility of
income. As a result, he places a much higher value on the $100 that might be taken out
of his current income than the $100 that might be added to it. Suppose for example, that
she obtains 150 units of pleasure or utility from the first, but only 100 from the second,
and that the pollution injures him/her by 120 units. The value of production to the
furniture maker is $100. In that case, if the liability is given to the furniture maker, the
most the furniture maker is willing to pay ($100), will not be sufficient for the furniture
maker to buy the right to pollute, because the home owner values the clean air more than
the incremental $100. However, if the furniture maker is not liable, the home owner will
not be willing to purchase the right because s/he values the $100 that comes out of his/her
current income by more than the clean air. In sum, if the marginal utility of income to
at least one trading partner is not constant, the underlying legal rule may determine the
outcome of the transaction. Variations of this observation are presumably stronger
when one of the bargainers is an individual, whom we presume experiences
declining marginal utility of income. If the bargainers are firms and the firms are thought
to be profit maximisers, then the marginal utility of income is generally thought to be
constant.

Finally, ‘efficient’ in Coasian terms really means nothing more than joint maximising.
Indeed, the resulting Coasian bargain may not be socially efficient at all. For example, if
the bargainers collectively have market power in some other market, the joint maximising
outcome might be one in which they agree to reduce output and sell at a monopoly price.
Thus the Coase Theorem very likely predicts cartels. If we assume that sellers, who are
few, can bargain with each other more cheaply than customers, who are many, sellers
may maximise their joint profits by charging a monopoly price or perhaps by agreeing to
engage in price discrimination. This is simply another way of noting that the Coase
Theorem is not a general equilibrium theorem. It is concerned only with the result in a
particular market, and that market may be very small.

These assumptions and limitations have made the Coase Theorem quite controversial.
Further, the Theorem’s ‘capture’ by Chicago style neoclassicists has effectively given
Law and Economics in the United States a heavily ideological, free market cast (see, for
example, Baker, 1975; Dworkin, 1980; Coleman, 1982; Klein 1988; Michelman, 1978;
Kennedy and Michelman, 1980).
Other, more recent literature on the Coase Theorem has dealt with the question whether it is really a ‘theorem’ at all, and whether it can be empirically verified. (The literature, which is large and growing, includes Hoff and Spitzer, 1982, 1985; Schwab, 1988; Harrison and McKee, 1985; see also Donohue, 1989.) This concern with verification might seem odd. The Coase Theorem is, after all, a theorem. ‘Verification’ consists in nothing more than determining the extent to which its assumptions obtain in particular real world situations. For example, if someone were to attempt to verify the Pythagorean Theorem (in a right-angled triangle, the sum of the squares of the legs equals the square of the hypotenuse), he would not in fact be ‘verifying’ the theorem at all, but merely determining the extent to which figures and structures found in the real world are precisely created right-angled triangles. The theorem itself is a tautology and cannot be verified; so too the Coase Theorem (see Hovenkamp, 1990C).

Law and Economics since 1960: main themes

Law and Economics has been ubiquitous in legal scholarship of the past generation. Indeed, one can hardly find a legal rule to which economic analysis has not been applied. For this reason, the discussion that follows is highly selective, concentrating on a very few major areas and themes, and on only a few writings within those areas. For a broader account, including numerous excellent bibliographies of the literature, one should consult Posner’s Economic Analysis of Law (4th edn, 1992). That book, originally published in 1973, is the closest thing there is to a ‘treatise’ on American Law and Economics. Although Posner is a committed member of the ‘Chicago School’, and shares most of that school’s ideological commitments, his book is nonetheless catholic in its outlook and rather tolerant of divergent viewpoints. Posner himself remains an unflinching neoclassicist and positivist. One weakness is that the book does not give adequate regard to the history of the discipline.

Debate over the Coase Theorem: herein, property and torts

Coase’s Problem of Social Cost inspired an outpouring of literature exploring its implications for property and tort law. Originally Guido Calabresi argued that in the long run the consequence of the shifting of a liability rule would be further investment in the area of activity that had been relieved of liability and disinvestment from the area of activity where liability had been assigned. As a result the variance thesis did not work; in the long run the amount of activity would be affected by the underlying legal rule (Calabresi, 1965, p. 730, n. 28). But Calabresi subsequently diluted this criticism, and others remarked that the way to conceive of the Coasian relationship is as two parts of a firm run by a common owner, who will always achieve the proportion of production that maximises overall profits (Calabresi, 1968; Nutter, 1968; Demsetz, 1972; Frech, 1979). Further, this proportion will not change simply in response to a change in the legal rule, for the firm will have to internalise the cost in any event. Of course, in the long run a shift in the liability rule may affect variable costs of operation, which will in turn affect prices and thus demand; so the firm to whom liability is shifted may produce more while the firm relieved of liability produces less (Cooter, 1982; Regan, 1972).

Other scholars explored the Coasian assumption of zero transaction costs, and the consequences of relaxing the assumption. This led to considerable analysis of the types of legal rules best calculated to yield efficient solutions in various markets. A ‘liability’ rule is a rule that protects by an action for damages. A ‘property’ rule is a rule that
protects by an action for an injunction, but the parties can bargain around the subject of the injunction. An ‘inalienability’ rule is also protected by an injunction, but the condemned act is positively illegal and cannot be authorised by the plaintiff through the device of a private settlement. Calabresi and Melamed argued that damages rules should be preferred in cases where valuations are easily made on the basis of public information and there is no problem of holding out (Calabresi and Melamed, 1972). Liability rules are preferred in cases where the transaction costs of negotiating outcomes are very high. For example, a property rule regime for accidents would require the parties to negotiate in advance of an accident for the price of an injury, such as the loss of an arm or leg. Since negotiating for such entitlements is difficult and, more importantly, most people do not know in advance whom they will injure accidentally or be injured by, only a liability rule regime will work (see Landes and Posner, 1987, p. 36). Inalienability rules might be thought most appropriate where the costs of assembling all those affected by a practice are very high—or to put it differently, where for any pair of bargaining parties, injuries or benefits to third parties are created that will not be accounted for in the bargaining process. For example, pollution may injure a large number of people, but only a few could effectively bargain about their interests, and holdout problems could be significant. In that case a regulation stipulating the amount of pollution or the amount of permissible injury might be better, with this amount being non-waivable by the parties. (The rule must be non-waivable because it is impossible to identify all affected parties and waiving the rule requires unanimous consent.) In fact, the proper scope of inalienability rules has been a subject of much dispute, and there is considerable support for the proposition that most such rules represent a paternalistic attitude or else are to be justified on distributive rather than efficiency grounds (see Polinsky, 1979, reviewing the literature).

Negligence and strict liability
Modern Law and Economics has produced a highly generalised theory of tort law, centring on the concepts of negligence and foreseeability, and providing a rationale for both negligence and strict liability rules. Negligence is generally defined in terms of the cost of an anticipated injury: an action is negligent if the cost of the precaution not taken is less than the amount of the injury multiplied by the probability that the injury will occur. Further, the party to the accident who can avoid the mishap at lowest cost should be the one that takes the necessary precaution—thus the common law rule of contributory negligence. If the expected cost of the accident is $100 and the defendant could have prevented the accident at a cost of $80, he will be liable. But if the plaintiff him/herself could have prevented the accident at a cost of $60, the defendant will not be held liable. Finally, the case for strict liability (liability without fault) rests on a finding that the optimal way to avoid some losses is to reduce the level of activity rather than the level of care with which the activity is exercised. This might occur when the activity is especially hazardous, or when the losses are truly catastrophic and the risk of occurrence cannot readily be computed (see Landes and Posner, 1987).

Contract
Explicit markets and the bargains that obtain in them occupy centre stage in most of microeconomics. By contrast, one effect of the Coase Theorem was to centre the development of Law and Economics around property rights and torts, both of which Coase’s article brought into the forefront. Nonetheless, ‘The Problem of Social Cost’ is

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1 As in United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947).
fundamentally an essay about contracting, emphasising situations where (1) the market at issue is not competitive (often it is a bilateral monopoly) and (2) transaction costs are high.

The Coase Theorem has profoundly affected analysis of contracts in Law and Economics.¹ The principal concern in microeconomics generally has been the specification of those conditions in which unrestrained contracting can yield Pareto optimal equilibria. By contrast, Law and Economics has been concerned mainly with ‘bilateralism’—or the rather specialised bilateral monopoly relationship that exists between contracting parties once they have invested resources in a bargain. To the extent these costs have been invested and cannot be recovered if the bargain turns bad or fails to form, the parties have an incentive to accept less than optimum results. This in turn gives opposites room for strategic behaviour.

The impact of this shift is seen in the Law and Economics literature on remedies (see Friedman, 1989; Kronman, 1978), the notion of efficient breach of contract (Polinsky, 1989) and the distinction between open-ended, or ‘neoclassical’ contracting, as opposed to the classical conception of contract as completed exchange (see Macneil, 1978; Geetz and Scott, 1981; for the historical development see Feinman, 1983). In all these cases the institutional role of the law is seen as producing the maximising result given the situation in which the parties find themselves at the moment of the dispute, when extraction is no longer costless.

The efficiency of the common law; government regulation

One particularly powerful argument in Law and Economics, particularly of the Chicago School variety, is that the common law is a more efficient mechanism for allocating resources than most forms of government intervention. The argument, which flows from the neoclassical interpretation of the Coase Theorem, really consists of two quite distinct parts. The first part argues that the common law is an efficient allocator of resources, since markets are presumably efficient and the common law seeks to mimic market outcomes. This argument has been subject to numerous variations. Among the most prominent are that efficient common law rules tend to outlast inefficient rules because inefficient ones are more likely to be challenged and thus more likely to give way. This is so because an efficient rule imposes higher aggregate costs on the parties than an inefficient rule does, and the rate of challenge presumably increases with the amount at stake. Indeed, Priest attempted to show that even if judicial decisions were random as to efficiency, a litigation process in which inefficient rules were litigated more frequently than inefficient ones would tend to yield efficient rules (Priest, 1977; Priest and Klein, 1984). The literature on this question is vast. (In addition to Priest’s contributions, see Rubin, 1983; Rubin, 1977; Terrebone, 1981; Nelson and Winter, 1982; Landes and Posner, 1979; Goodman, 1978.)

The other part of the argument is that government regulation is largely inefficient. In some cases it is calculated to transfer wealth to small groups of well-organised rent seekers (see Buchanan and Tullock 1962; Buchanan, Tollison and Tullock, 1980; Posner, 1974). For surveys of the vast literature, especially insofar as it affects legal policy, see Farber and Frickey, 1991; Hovenkamp, 1990B. In other cases, regulation produced within the democratic system produces such haphazard results that they simply

¹ Two good collections of essays are Kronman and Posner, 1979; and Goldberg, 1989.
cannot be justified on efficiency grounds (Arrow, 1963, p. 7; see also Hovenkamp, 1992; Hovenkamp, 1990A).

This comparison has led to a general critique of regulation, even in areas thought to be rife with market failure, such as land use planning (e.g. Siegan, 1972; Ellickson, 1973). It has also led to arguments that judicial power and sometimes even the Constitution should be used to preserve market orderings over those prescribed by inefficient legislation. (For a good introduction to the issues, see Easterbrook, 1984; Easterbrook, 1983; Posner, 1982.)

Recently, however, the case for regulation has appeared more strongly within the economics literature, resting mainly on the propositions that (1) imperfections in the legislative process are not essentially worse than those in private markets, which can also be substantial; and (2) legislative imperfections can be compensated for (e.g. Sunstein, 1990). Further, Priest's argument for the common law's efficiency seems vulnerable to some substantial critiques. First, under a fairly weak set of assumptions the common law process that Priest's theory describes appears not to yield an efficient equilibrium. Rather it yields a cycle in which the proportion of efficient and inefficient rules varies with the nature and proportion of the challenges. For example, if an efficient rule is three times more likely to be challenged than an inefficient rule, the equilibrium situation would more likely be one in which three-quarters of the time the efficient rule prevailed, while one-quarter of the time the inefficient rule prevailed (Cooter and Kornhauser, 1980).

Second, the argument for legal efficiency does not adequately distinguish common law rules from regulation unless one applies different assumptions about human rationality. The reason those who oppose inefficient regulation fail to prevail is supposedly various free rider problems that make special interests more effective lobbyists than general interests are (as in Buchanan and Tullock 1962). But the same thing generally applies to litigation. For example, a common law rule that injures a relatively small group of actors with a large stake and homogeneous interests is more likely to be challenged than a common law rule that injures a larger group whose individual injuries are smaller and whose interests vary.

The Nature of the Firm and the regulation of corporations

Since the 1970s, most of the work by Law and Economics scholars concerning the nature of the business firm has built on the basic insights of Ronald Coase. In 'The Nature of the Firm' (1937) Coase argued that the relevant determinants of firm size and structure could be located entirely within neoclassical (marginalist) price theory. Coase argued that use of the market is costly, and that a firm's managers seeking to maximise profits will acquire an input or make other relevant decisions according to whatever is least costly at the margin. Thus, for example, if the manufacturer of toasters must choose between making its own electric cords or purchasing them from others, it will choose the least costly, taking all relevant transaction costs into account. The same type of decisions will govern the firm's mechanism for determining whether it will wholesale its product to independent resellers or integrate vertically into retailing itself.

Economic analysis of the business firm long antedated Coase's important article. Indeed, already in the nineteenth century the legal rules respecting the business corporation had assumed an architecture quite distinctly based on classical political

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1 For the theoretical basis, see Becker, 1985, p. 120; Becker, 1983.
One of the central features of Progressive Era and New Deal institutionalism was the economic analysis of business firms, and a sharp critique of the corporate law of that era (Veblen, 1904; Veblen, 1923; Commons, 1924). The culmination of this work, which emphasised various inefficiencies or social evils that resulted from the separation of corporate ownership and corporate control, was Berle and Means highly influential The Modern Corporation and Private Property (1932).

Since the 1960s Coase’s Nature of the Firm has been read by many as if it undermined this institutional critique by assuming that firms themselves are efficient markets, in which the separation of ownership and control should either be ignored or simply considered as a type of transaction cost capable of being managed. (For example, if separation of ownership and control creates inefficiencies, then perhaps the firm should become smaller.) Coase himself contributed to this view by ignoring Berle and Means’ book, which had been published five years earlier. This is the view that largely prevails today in Law and Economics (see, for example, Easterbrook and Fischel, 1991). The corporation is viewed as a device for reducing the transaction costs that attend large scale production, and the optimal corporate law regime should facilitate the reduction of such transaction costs by discovering what amounts to intra-firm ‘market failures’ and adopting legal rules that will do in fact what the parties would have done under conditions of costless contracting and perfect information. For example, limited liability of corporate shareholders is defended with an argument that the parties themselves would have bargained for it in order to reduce the transaction costs, particularly information costs, respecting investment. If corporate law is efficient the value of the firm will be maximised, because the difference between its costs and the value of its production will be maximised. Importantly, Coase assumed that firms either maximise profits or should be treated by the theorist as if they do. By contrast, Berle and Means argued that the separation of ownership and control led to many situations in which firms fail to maximise profits.

A rich alternative tradition in the analysis of business firms has been prompted by the work of Oliver E. Williamson, also building on Coase’s ‘The Nature of the Firm’, except emphasising that the role of transaction costs is much larger than the neoclassical tradition allows (Williamson, 1975, 1985; see also Klein, Crawford and Alchian, 1978; and the essays collected in Williamson and Winter, eds., 1991). In general, this tradition views markets as somewhat ‘lumpier’ than traditionally assumed, and thus sees a broad range of imperfections that explain both long-term vertical contracting and the formation of firms.

Since the market alternative is relatively less efficient, the formation of firms as an alternative may be less efficient as well. That is, the formation of a firm is justified any time it is more satisfactory than the market alternative. The more imperfections that the market contains, the more imperfections will be tolerated within the firm before market alternatives are sought out (see Hovenkamp, 1993B). Within this tradition, failure of profit maximisation is once again taken seriously.

**Individual utility maximisation: criminal law, family law**

The traditional domain of the Coase Theorem was the business firm, which in neoclassical economic theory is presumed to maximise profits. But human beings maximise utility, not profits. Law and Economics becomes more venturesome and
speculative when it must deal with the utility maximising individual rather than the profit-maximising firm. This is so for two reasons. First, an individual’s utility function may include other things than wealth. Second, individuals presumably have different utility functions, and strictly speaking, interpersonal comparisons of utility are not possible. As a result, devices such as cost-benefit analysis, which attempt to measure efficiency on the basis of observed willingness to pay, may be a perfectly appropriate device for measuring the wealth effects of a governmental policy, but they may not work at all for measuring utility effects on individuals (see, for example, Hovenkamp, 1991B).

These problems have emerged in numerous areas of Law and Economics, but particularly interesting are criminal law and family law.

In criminal law the basic paradigm in the case of the profit maximising firm is relatively clear. The optimal criminal sanction should be just enough to deter the criminal from engaging in the harmful activity (Posner, 1985). If the sanction is any harsher, then a criminal may not be constrained from committing a greater offence. For example, if both robbery and murder are punished with death, the robber who had committed the first crime would not be constrained from committing the second as well. An optimally proportional legal rule would be precisely sufficient to make the crime unprofitable, allowing for the risk of nondetection. For example, if the value of the theft to the criminal is $100 and the probability of detection is 1/3, then the optimal penalty would be a fine of approximately $301.00, or just enough to make the theft unprofitable. In addition to providing different levels of deterrence for different gradations of crime, the value of making the penalty only slightly greater than the anticipated harm is positive when the activity has some possibility for being socially beneficial. In that case, too high a penalty may eliminate conduct that is, on balance, efficient.

Although this rule may make considerable sense when applied to business criminals, applying it to biological persons is much more speculative. For example, criminals may often obtain satisfaction from their crimes unrelated to the financial gain. In many situations, such as rape or child molesting, the criminal may not reap any financial gains at all. In that case, the optimal sanction must deprive the criminal of an amount of utility which, when discounted by the risk of detection, will make the crime unattractive to the criminal. Clearly, however, calculating the optimal sanction even for a single criminal now provokes serious problems of measurement. How does one balance the disutility of a given amount of incarceration against the utility derived from a particular crime? Further, coming up with a generalised punishment would certainly require interpersonal utility comparisons of the grossest sort.

The same problems arise with respect to family law. Although some of the most interesting recent work in Law and Economics has analogised the family to a business firm, the argument can be pushed only so far without running into problems of interpersonal utility comparisons. The device that has facilitated the expansion of economic inquiries into this area is the concept of ‘human capital’, which for many purposes turns the human utility function into a kind of production function. Thus, for example, Richard Posner begins his analysis of family law with the

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1 Although the example is widely cited as a staple of the modern Law and Economics movement argument for marginal deterrence, it in fact originated with Bentham in the late Eighteenth Century: ‘A highwayman may content himself with robbing, or he may begin with murder, and finish with robbery. The murder should be punished more severely than the robbery, in order to deter him from the greater offence’ (Bentham, 1864). For further discussion, see Hovenkamp, 1993A.
perception that the household is not merely a consuming, but more importantly a producing, unit in society. The food, clothing, furniture, medicines, and other market commodities that the household purchases are inputs into the production of nourishment, warmth, affection, children, and other tangible and intangible goods that constitute the output of the household. (Posner, 1994, p. 139)

This type of analysis was greatly facilitated by the innovative, often unorthodox work of Gary Becker, who did as much as anyone to push economic analysis outside the traditional areas involving the commercial marketplace (see Becker, 1991, 1976, 1975).

The concept of human capital, or of the human being or family as a productive unit, has not yet been pressed as far as it could be into the area of the welfare state, or of economic justifications for wealth redistribution. At one time it was widely believed that marginal utility theory provided a broad defence of such policies, since it could be shown that the poor had higher marginal utility for a given amount of money than did the rich. As a result, a forced wealth transfer from wealthy to impoverished would increase national welfare, provided that the transfer did not produce collateral costs.¹ The foundation for such arguments was widely thought to be destroyed, however, by the observation of Lionel Robbins and others that implicit in them were impermissible interpersonal comparisons of utility (Robbins, 1932). Thus the ‘new’ welfare economics of the 1950s and after found little justification for wealth redistributive policies such as welfare laws or graduated income taxes.

But the concept of human capital, carried to its logical conclusions, seems to re-open the entire problem by effectively re-conceiving the human being as a production rather than consumption unit. A business firm, after all, has no ‘utility’ function, but only a production function. With such a function one can easily increase total productivity across two or more plants by equating marginal outlays. Thus, for example, if optimal production in each of two plants requires ten tons of coal per month but the plants are currently receiving twelve tons and eight tons respectively, the manager can increase productivity by transferring two tons from the former to the latter. The premise that the human utility function is nothing other than a production function yields much the same set of conclusions. A policy of maximising the total value of a society’s human capital may require redistribution of wealth, educational opportunities, and the like, that are little different from the goals of a welfare state defined by interpersonal comparisons of utility.² These implications have been little explored, but their potential seems vast.

Jurisprudence: Kaldor–Hicks efficiency and wealth maximisation as social goals

Neoclassical Law and Economics generally proceeds on the assumption that evaluating legal rules for their allocative efficiency is a useful enterprise. Since many legal rights and entitlements are not traded in markets (or the exchanges are involuntary), efficiency analysis of legal transactions is more venturesome than efficiency analysis of private

¹ As in Arthur C. Pigou, 1924. Important Americans included: John R. Commons, 1893, p. 10: (‘To the poor man all the marginal increments may afford high satisfaction, because his supplies are limited; but to the rich man the marginal increments may give little satisfaction.’); Simon Patten, 1894 (same); Frank Taussig, 1921, vol. 1, p. 132: (‘The principle of diminishing utility, if applied unflinchingly, leads to the conclusion that inequality of incomes brings a less sum of human happiness than equality of incomes, and that the greater the inequality, the less the approach to maximum happiness.’).

² Interesting work on the ‘biological’ nature of the human utility function, relating it to survival and productivity, includes Hirschleifer, 1977; Becker and Murphy, 1988.
markets generally. For example, instead of adopting the efficiency criterion of Pareto optimality, which is easily applied only to voluntary transactions, those engaged in Law and Economics most often use ‘potential’ Pareto optimality, or Kaldor–Hicks efficiency. A particular outcome, such as an involuntary wealth transfer, is Kaldor–Hicks efficient if those who gain from the outcome can fully compensate the losers for their losses and still have something left over. For some, economic analysis of law is best defined as the efficiency analysis of legal rules, with efficiency measured by the Kaldor–Hicks criterion.1

But a few people, in particular Richard Posner, have made the additional claim that Kaldor–Hicks efficiency, or wealth maximisation, is the driving principle of justice (Posner, 1981). That claim is itself normative, and probably not within the boundaries of neoclassical economics. Further, it has been subjected to several criticisms. One criticism is that there is little evidence that people as a group are happier under wealth maximisation than they are under alternative regimes (Baker, 1975). Further, in the presence of a substantial ‘endowment effect’—that is, where people’s willingness to pay for a particular entitlement exceeds their willingness to accept for the same entitlement—it cannot be shown that competitive markets without state intervention will yield the wealth maximising state of affairs (see Hovenkamp, 1991B). Third, when compensation is not actually paid, Kaldor–Hicks tests demonstrate ‘efficiency’ or welfare gains only on the assumption that all persons derive equal welfare from a marginal dollar, at every level of wealth. This requires interpersonal utility comparisons beyond even those made by pre-Ordinalist marginalists such as Pigou and Marshall (see Coleman, 1988, esp. chs. 3 and 4).

Critiques: ‘post-Chicago’ Law and Economics

Any talk of a ‘post-Chicago’ Law and Economics may seem premature. Indeed, recently two Chicago architects of Law and Economics have won the economics Nobel Prize (Ronald Coase, 1991; Gary Becker, 1992). One of the consequences of the great success of Law and Economics movement, however, is that its influence and fundamental disciplinary approaches have spread widely, taking in many who do not have the same ideological or historical commitments as are commonly associated with the University of Chicago. To put it another way, ideological diversity seems to be a consequence of the great success of Law and Economics, rather than of its failure.

But whatever the cause, many writers are departing from the perceived Chicago orthodoxy (see, e.g. Symposium, 1989). Some have argued that, whatever role the conception of the rational actor may have in formal economic analysis, legal analysis requires a richer, more substantive notion of what rationality means. Apropos of this, Law and Economics should accommodate other social sciences, such as psychology, much more readily (see, e.g. Etzioni, 1988; Ellickson, 1989; responding is Posner, 1989). Others have argued that the Chicago-inspired dichotomy between efficiency and

1 See Posner, 1987. Kaldor–Hicks efficiency must be supplemented, however, by Scitovsky’s requirements that losers not be able successfully to bribe the gainers in return (see Scitovsky, 1941). Scitovsky’s paradox notes that cost-benefit analysis can produce intransitive results when a lump sum wealth transfer has large wealth effects. Suppose for example that the marginal utility of money is inversely proportional to the amount that one has. Individual A currently has $100 and obtains 10 utils from a marginal dollar. Individual B currently has $50 and obtains 20 utils from a marginal dollar. Proposed legislation will transfer $50 from A to B. After the transfer A will have $50 and obtain 20 utils from a marginal dollar, while B will have $100 and obtain 10 utils from a marginal dollar. Someone looking at the situation would conclude that a transfer from A to B will increase welfare by 500 utils; but a subsequent transfer from B to A will also increase welfare by 500 utils. In short, A is preferred to B, but B is also preferred to A, depending on the status quo.
distribution is wrong-headed and that often the efficiency of legal outcomes cannot be studied apart from distributive consequences (Coleman, 1988; Coleman, 1989). Yet others have argued that Chicago Style Law and Economics uses two different, inconsistent conceptions of rationality—an optimistic robust concept in its discussion of market efficiency, and a much weaker and more pessimistic concept in its discussion of rational democratic decision making. These inconsistent conceptions of rationality, not the substantive proofs, drive the conclusion that decision making in private markets is more efficient than decision making in deliberative governmental bodies (Hovenkamp, 1992).

Other critiques are actually not ‘post-Chicago’ at all, but may actually precede it. For example, libertarians have long been critical of Law and Economics for being too willing to subordinate fundamental questions about justice and property rights to a kind of cost-benefit analysis where nothing is considered as ‘fundamental’ (e.g. Buchanan, 1974).

Finally, a growing area of Law and Economics emphasises game theory and argues that more well-established approaches do not consider strategic behaviour with sufficient care. (For a good introduction, see Rasmusen, 1989.) In general, game theory becomes most relevant to law and economics when one relaxes the assumption that each participant to a bargaining or litigation process has perfect information, or alternatively, the state has not provided adequate mechanisms for enforcing a particular kind of bargain. For example, the classic prisoners’ dilemma in game theory is nothing other than a kind of bilateral monopoly in which neither side has good information about what the other side will do; or alternatively, where any prior agreement between the two prisoners (such as, that they will not talk if arrested) cannot be enforced. Such situations may not result in a stable equilibrium at all. Alternatively, they may produce Nash-Cournot equilibria1 that are inefficient in two senses. First, they are not Pareto optimal; if the parties could engage in traditional bargaining they would have reached a different agreement. Second, they are not joint maximising. In the last few years game theory has been applied to a wide variety of areas relevant to legal policy, including informal dispute resolution (as in Ellickson, 1991), bankruptcy (Bulow and Shoven, 1978), plea bargaining (Reinganum, 1988), contract theory (where the many contributions include Katz, 1990; Ayres, 1989; Birmingham, 1969), antitrust and competition policy (e.g. Wiley, 1987; Ayres, 1987; Brodley and Ma, 1993), blackmail (see Symposium, 1993), and divorce law and property settlement (e.g. Mnookin and Kornhauser, 1979) to name only a very few.

In the expansion of Law and Economics to include game theory, the Chicago School has largely been a follower rather than a leader, although the point should not be pushed too far. First, Chicagoans raise the traditional positivist complaint that so many of the hypotheses of game theory are incapable of being tested (e.g. Peltzman, 1991). But more fundamental perhaps is the ideological consideration that game theory tends to undermine the Chicago School faith in the efficiency of markets and their superiority over regulatory alternatives.

**Conclusion**

Law and Economics has always suffered from a failure to be critically self-conscious about its methodology. Posner’s own stated methodology (e.g. Posner, 1989, p. 61; 1A Nash-Cournot equilibrium is a state of affairs such that, assuming the amount of information each person has remains the same and that the opposite person does not change his position, the optimal choice for the actor is to adhere to his position as well.
Posner, 1992, p. 17) continues to be a kind of positivism advocated by Milton Friedman in the 1950s (Friedman, 1953) and now virtually abandoned in all the social sciences, including economics, as excessively scientific (see, e.g. Redman, 1991, esp. ch. 9; Rosenberg, 1986; De Long and Lang, 1992.) Further, practitioners of Law and Economics are completely unable to do in practice what Friedman's brand of positivism describes. Because law generally deals with implicit rather than explicit markets, much of the economic analysis of law consists in story-telling, confirmation, and finding plausible explanations—not rigorous falsification of hypotheses (see Crespi, 1991; Hovenkamp, 1990D; Johnston, 1990; Coleman, 1984). A sensible methodological approach would be to face this fact explicitly; in the process, Law and Economics could be made much more useful to the legal policy maker, for whom the only relevant experience is often anecdotal. Unfortunately, alternative methodologies remain largely unexplored. More specifically, Law and Economics in the United States has paid too little attention to the explicitly institutional aspects of Ronald Coase's work, perhaps because the institutionalism of the 1910s and 1920s has been regarded by neoclassicists as so thoroughly discredited. Be that as it may, it is difficult to think of the economic study of law and the authorities that make it as anything other than an institutional enterprise.

The greatest successes of Law and Economics thus far have lain in its normative studies of legal rules and institutions affecting choice, and its empirical studies of the efficiency effects of legal rules. Because of its strongly neoclassical, ordinalist biases, Law and Economics in the United States has been considerably less useful as a device for evaluating welfare policy, or legal policy respecting the distribution of wealth. But for the legal policy maker, concerns about distribution cannot be relegated to second place, in the way that welfare economics is so often considered a second class citizen among economics' many disciplines. For this reason, the study of human welfare as well-being, whether measured by production or consumption, seems to be among the least complete of the agendas of Law and Economics.

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