

# Law and Economic Theory: An Economist's View

By ALVIN K. KLEVORICK\*

Taking stock of the realized and potential contributions of any area of intellectual endeavor is a difficult task. The assessment process is even more difficult if the field is relatively young and if it is interdisciplinary. Such is the case with law and economic theory. In this paper, I will attempt to give my view, as a participant in the law and economics enterprise, of the types of contributions economic theory can make to law—to legal decision making, to the study and development of legal doctrine, and to the study and analysis of legal structure. These views should be understood as simply *an* economist's view. I make no attempt to describe what must be a wide spectrum of views held by economists working in the area, and I certainly make no pretense to present the views of the lawyers engaged in this joint enterprise.

The first kind of contribution an economic theorist can make in law arises when economic concepts become important in understanding some aspect of a particular legal case. Although the overall question raised by the case may not be economic in nature, at some point an understanding of how markets work, how markets value commodities, services, and assets, and how individuals interact in their economic roles may become critical in deciding the ultimate disposition of the case. One can take an example as basic as the valuation of a capital asset. Suppose, for example, that through some set of circumstances (which we will not inquire into now), *A* has destroyed *B*'s widget-making machine. The

latter has no sentimental attachment to his machine, but values it only for the widgets it enables him to produce and sell. Without inquiring how the court reaches this position, suppose the court decides to award *B* an amount in damages equal to the value of the machine *A* has destroyed. An economist armed with his understanding of how markets value capital assets should be able to help the court in deciding the appropriate amount for *B* to receive in damages, given the court's decision that *B* should be compensated for the loss he has incurred because of *A*'s destruction of the machine. An economist should also be able to help the court if *B* returns, as some real-world plaintiffs have, and asks for compensation, *in addition to* the amount the court has already awarded him, for the loss of profits he will incur until he can replace his widget-making machine with the new one he has just ordered.

In such a situation, the economist essentially plays the role of technician. He takes the problem facing the legal decision maker framed the way the legal decision maker has posed it, and he brings his expertise to bear in dealing with a specific part of the case. The economist draws upon his understanding of the way in which particular functions of society are performed, and he uses that understanding to shed light on specific issues in a given case. It is not a terribly imaginative role, but it is undoubtedly a terribly important one.

The second type of contribution an economist can make to law might be described as the economist in the role of "supertechician." Once again, the economist takes the problem as set by the lawyer

\* Yale University.

or by the legal decision maker, but in this instance the entire structure of the problem area has economic roots. The objectives and design of the institutions and doctrine are explicitly stated in economic terms, and the economist is called upon to evaluate and give advice about the best ways to achieve the specified objective(s). Most of the traditional areas of interaction between law and economics would fall, I think, into this category. They include, for example, the areas of antitrust law, public utility regulation, and labor law. When the issues at hand concern the most efficient way, or at least more efficient ways, of structuring an industry or a sector of the economy or the relationship between economic agents, the question comes ready-made for the economist to make an important contribution.

One particularly important function the economist can play in his role as super-technician is to question whether the legal decision maker's general approach in a particular area actually helps to achieve the end the legal decision maker has in mind. For example, putting aside for the moment the multiplicity of reasons and rationales that might lie behind the institution of public utility regulation, suppose the legal decision maker asserts and believes that the primary objective of a system of public utility regulation is efficiency in the economist's strictly defined sense. The economist should be able to point out the kinds of characteristics commonly associated with natural monopoly and the kinds of characteristics which might suggest the need for special concern about the efficient functioning of an industry. He can help to focus the discussion to see whether the industry for which regulation has been proposed is indeed a natural monopoly. If the answer is yes, the economist can—and should—then suggest to the decision maker the variety of possible responses to the natural monopoly situation, responses rang-

ing from having the natural monopoly privately owned and unregulated, to the general type of public utility regulation we have today, to an alternative type of regulation, or, finally, to public enterprise.

One thing the economist should do is provide the decision maker with an evaluation of the advantages and disadvantages of each of these alternative approaches. He should frame the discussion so that it encompasses not only the direct impacts each of these systems will have on the efficiency of the sector or industry whose regulation is being contemplated, but also the side effects or indirect effects that such regulation might have on this industry and its consumers and on other industries and other consumers in the economy. It would also seem to be incumbent upon the economist to try, to whatever extent possible, to indicate the income- (or wealth-) distributional impacts of such a regulatory policy. For although we have assumed (for the sake of this discussion) that the avowed and true goal of the decision maker's use of regulation is to achieve efficiency, there are undoubtedly some tradeoffs between efficiency and distribution in the choice of a response to the natural monopoly problem, and the economist is particularly well suited to the task of pointing out what kinds of tradeoffs exist. Of course, while most of my discussion is concerned with the role of the economic theorist, the kinds of judgments that would be important, indeed critical, in such a balancing act are empirical judgments (and empirical guesses if hard data do not exist concerning these alternative costs and benefits). But even the theorist can help, and should help, to focus the discussion at the level of a comparative institutional analysis—a comparison of the alternative systems available for trying to achieve the given objectives.

In the context of this role as super-technician, the economic theorist can also have

a considerable input in designing the particular legal structure that is eventually chosen to cope with the given legal problem. For example, in the public utility area the economic theorist may be able to indicate which kinds of regulatory structures are most likely to achieve the goal of efficiency. He would be able to delineate, from an efficiency point of view, which kinds of issues are best handled using automatic adjustment clauses and which types of issues are best thrashed out in an alternative procedural setting.

In sum, when the economic theorist acts as a supertechnician for the lawyer, he draws on his expertise in analyzing a problem posed by the lawyer, just as he did in the role I described as economist as technician. But now the problem he is addressing is in its own terms economic in nature.

The third role I see for the economic theorist in the joint enterprise of law and economics is one that has come to flourish quite recently. Put briefly, it envisions the economist or economic theorist as the propounder of a new vocabulary, a new analytical structure for viewing a traditional legal problem. In contrast to the economist's approach in the first two categories of interaction I discussed, in this third role he no longer takes the problem as framed by the lawyer. Rather he takes the general problem area with which the lawyer is concerned—say, torts, or property, or procedure—and poses in his own terms—that is, in economic terms—the problem he sees the legal structure or legal doctrine confronting. He provides, thereby, a different way of looking at the legal issue which yields alternative explanations of how current law came to be what it is and new proposals for new law.

In the area of torts, for example, some economic theorists have posed the problem facing society as minimization of the expected social costs of accidents, taking account of: the costs incurred when accidents

occur and the probabilities that such accidents will occur; the relationship between those accident costs and probabilities and the steps people take to avoid accidents; the costs of the resources devoted to avoiding accidents; and the costs of any administrative structure used to make decisions about the optimal level and allocation of these several kinds of costs among members of society. Economic theorists have used this type of framework to discuss and evaluate the traditional negligence rules, to provide a critique of the fault system of accident law, and to evaluate new proposals for automobile accident law, for example, no-fault plans. To take another example, the design of a system of civil procedure, criminal procedure, and judicial administration has been formulated by some lawyer-economists as the problem of minimizing the sum of the social costs of resources devoted to such procedural systems and administrative mechanisms plus the error costs of those procedures. This framework has then been used to evaluate various specific aspects of procedure and judicial administration: for example, the discovery rules of the Federal Rules of Civil Procedure, the bail system, the existence of plea bargaining, and the use of the jury.

This third role is probably the most exciting one the economic theorist can currently play. This form of interaction with the lawyer appears to be the most creative and the most challenging. Hence, it is interesting to ask whether particular kinds of problems confront the economist when he presents a new vocabulary or a new structure for analyzing a legal problem. I think two such problems are particularly important—one arises from a constraint imposed by the economist's tools while the other is a limitation imposed by the lawyer's formulation of the problem area.

The constraint imposed by the economist's tools is perhaps seen best in the con-

text of a concrete example. Consider the problem of designing a set of liability rules for accident law in the world in which we live today. It should be clear that any attempt to analyze reality, to make meaningful statements about it, requires some abstraction from the richness of the phenomena being studied. The lawyer's world view is an abstraction just as the economist's is. The economic theorist's approach is to begin with the simplest possible model which captures important structural elements of the problem and to analyze that model as carefully as possible. As a theorist, I think this is a wise strategy. Having analyzed the simplest model, one might then proceed by relaxing some of the unrealistic assumptions which made one's first construction so tractable. For example, one might assume at the first step that all accident costs are, in fact, known to all parties making decisions about what levels of care to exercise. The second level of analysis might involve a relaxation of that assumption and a recognition that some parties will not be fully aware of these costs. The single (certain) values individuals attached to accident costs in the first model might now be replaced by subjective probability distributions people have about the accident costs that will be incurred.

Now suppose that in the simplest model several different liability rules would each yield the full-information social optimum by leading individual decision makers to attain the social-cost-minimizing combination of care levels. As one relaxes the assumptions of the model, the set of liability rules that will achieve the social optimum will undoubtedly become smaller. Further relaxations of the original assumptions—further gropings toward a more realistic representation of the world and people's decision-making processes—will undoubtedly reduce even further the number of liability rules that yield the social-cost-

minimizing solution. Indeed, it is most likely that before long the set of socially optimal liability rule structures will become empty. In short, there is no first-best solution in the real world or, for that matter, in the most complicated, yet tractable model we may construct.

The question then is: If the economic theorist is going to use his theoretical analysis to make policy recommendations, how should he proceed? It would be tempting simply to consider those policies that were socially optimal in, say, the next-to-the-most complicated model he had. The problem with this, of course, is that the order in which the theorist relaxes his original assumptions to arrive at the most complicated model he analyzes—that is, the path that leads to the continually shrinking set of socially optimal policies—has no particular normative justification. He could follow an alternative complicating path which might well generate an alternative second-best policy.

The realization that we are making decisions in a second-best (indeed, an  $n$ th-best) setting does not imply that the theorist's models and analyses should be dispensed with or ignored. Nor should the second-best nature of the decision problem be used by the economist as an excuse for avoiding statements of a policy nature. To evaluate alternative policies, however, the theoretical model must be used in conjunction with careful, empirically rooted judgments (guesses?) about which of the theorist's original simplifying assumptions are most likely to affect the applicability of his model's results. And the order in which the theorist relaxes these assumptions in building successively more realistic models need not reflect the empirical importance of the various assumptions. Hence, there is no reason to evaluate second-best policies by simply removing, in reverse order, the complications introduced to obtain the most realistic model.

The theorist can contribute in two ways to the comparative institutional analysis the law and economics enterprise should produce in such situations. First, by providing a new and different way of looking at the traditional legal issue, he will, hopefully, provide clarification and new insights into that issue. Second, he will provide an indication of the kinds of empirical guesses that are needed in order to use his theoretical investigation for policy formulation in the world in which lawyers actually operate.

A different, but equally important, difficulty arises when the economic theorist provides a new vocabulary for a problem which the lawyer poses in a form not really amenable to economic analysis. While the theorist might be tempted to show how his analytical structures can be applied to particular issues in such areas, it is simply the case that his tools are inappropriate to the overall task. I have particularly in mind those areas in which lawyers or legal scholars have framed the legal question in process-oriented rather than outcome-oriented terms, that is, as a question about how a decision will be made rather than about what the decision will be. Questions of institutional competence, questions of whether a particular issue is one that should be taken up by legislatures or by courts, are questions which are not easily comprehended within the economist's framework.

The issue as posed by the lawyer in such cases does not seem to be rooted in the search for some neatly defined social optimum—be it the maximum of a social welfare function or the minimum of some social cost function. The problem is not framed as the search for an *efficient* way of reaching a decision or deriving a structure of rules, but rather as the determination of the "*appropriate*" way of reaching a decision or the "*appropriate*" institution to use to decide the particular issue. And the

question of appropriateness is most likely to be resolved by appeals to history, to political theories of democracy, and to sociological theories of the role expectations of different members of the society. This is not to say that the economist's analytical structures cannot provide some help in examining these questions. In particular, when the lawyer appeals to political theories of democracy to help decide which institution is appropriate, he may well benefit from consideration of voting models and other models of the political process developed by theoretical economists and political scientists working in the area of public choice. The point simply is that when the lawyer or legal scholar has framed the problem in process terms, focusing on the appropriateness of one institution rather than another to perform a particular function or to make a particular decision, the lawyer is least likely to be receptive to the economist's vocabulary, rooted as that is in terms of a search for efficient structures, for efficient decision-making processes, and the like.

To be sure, questions of relative institutional competence can be stated in economic terms. One can talk about which institution has a comparative advantage in performing which function. We can ask whether courts or legislatures are "better" at developing liability rules, whether courts or administrative agencies are "better" at determining the value of a fair rate of return to a public utility, whether legislatures or courts are "better situated" to decide which interests are fundamental and which interests are not (alternatively, which wants are merit wants), or whether the judiciary or the legislature or the executive is the appropriate institution to decide if and when prior restraint over publication should be exercised. One can use the terminology of economics and talk about the costs and benefits of using one institution rather than the other. But when

the legal scholar has posed the problem in process terms, the analytical structure the economist offers for the given legal issue may not prove very helpful to the lawyer.

Let me try to illustrate this point with two examples. The first concerns freedom of speech. I believe that the economist (or the lawyer-economist) can contribute to our understanding of and deliberation about the appropriate scope for freedom of speech by taking seriously a concept which many Justices and legal scholars have invoked in their discussions of First Amendment freedom of speech issues: the marketplace of ideas. The economist can contribute by taking such references to the marketplace of ideas as something more than simply rhetoric—as, instead, an attempt to invoke what appears to the lawyer to be an appropriate analogy. Then, by bringing to bear his understanding of the ways in which markets work, of the potential sources of market failure, and of the possible responses to such market failures—all within a comparative institutional analysis framework—the economist may provide interesting observations (at least in efficiency terms) about possible arguments justifying and opposing limitations on freedom of speech in specific situations.

Exploiting the analogy of the marketplace of ideas, the economist can, I believe, provide a clarifying view of some aspects of the development of legal doctrine in the First Amendment area, for example, “the clear and present danger” test and its development and application in the case law. But suppose the legal scholar’s formulation of the First Amendment issue takes the form of the question: Which institution or which branch of government is the *appropriate* one to determine the scope of First Amendment rights? For example, suppose that the majority of a duly elected legislature believes that advocacy of a particular political philosophy poses an imminent danger to the nation. The legislature enacts

a statute making advocacy of the particular political views a criminal act. The legal scholar might ask: How deferential should a court be to the legislature’s judgment if a suit is brought challenging the law? The economist’s analysis and interpretation of the development of judicial doctrine may not be very helpful to the lawyer or legal scholar in answering this question.

The second example concerns whether juries in criminal trials should be representative, whether they should represent a cross section of the community. Here I think the economist can help in evaluating how effective representativeness of the jury is in furthering performance of the jury’s fact-finding function. He can suggest and explicate the analogy between the selection of a jury and the selection of a portfolio of assets by an investor. Pursuing this analogy, with the consequent delineation of the similarity between representativeness of a jury and diversification of an investment portfolio, the economist can draw upon portfolio selection theory to suggest the kinds of circumstances under which representativeness would make the jury a more effective fact-finding body and the types of situations in which representativeness would not serve that end. I think that introduction of the economist’s vocabulary in this discussion is interesting and helpful. But if the question of jury representativeness is framed not in the instrumental sense of achieving some further objective, like fact finding, but rather in more process-oriented terms, which would have a representative jury as the *appropriate* type to decide criminal cases, then the economist’s vocabulary is much less likely to clarify and illuminate the issues for the lawyer.

We come now to the question of what happens after the economist has proposed a new vocabulary for viewing a traditional area of legal concern. One possibility, of course, is that the new vocabulary will

simply be rejected, and I have tried to indicate at least one reason why that may occur. A second possibility is that the new vocabulary, the new way of viewing the problem, will come to displace the old. While I regard this outcome as highly unlikely, it nevertheless suggests the major danger that I see, and that I hope will be averted, in the application of economic theory to legal problems: namely, a type of intellectual imperialism on the part of the economic theorist or the lawyer-economist. It is the danger that, having created or at least suggested a new vocabulary for viewing the legal issue, the economic theorist or the lawyer-economist will develop—or even worse, try to generate in others—a form of tunnel vision in which he sees the new vocabulary as the only “reasonable” one for viewing the area. While I firmly believe that economics can make a contribution to law and that economic theory in particular can make such a contribution, I do not believe that the analytical grid the economic theorist imposes on the legal problem is the only one worth examining.

The most likely result of the economist's suggestion of a new analytical structure is the coexistence of his new approach to the problem with other, perhaps more traditional, approaches to it. For example, thinking of civil procedure as designed to minimize the sum of the direct costs and error costs of procedure will come to co-

exist with an understanding of certain elements of procedure as generating or guaranteeing a sense of fairness in the way our legal system operates. Our system of tort law will be understood both in terms of minimization of the social costs of accidents and in terms of noneconomically based ideas of causation and reciprocity.

Economic theory's contribution to law is likely to be greatest if, in proposing new analytical structures for traditional legal issues, the economist or lawyer-economist takes a constructive eclectic view and welcomes the contributions other social scientists may be able to make to our understanding of these areas. For psychologists, historians, sociologists, and others can also suggest new and potentially useful approaches to legal issues, approaches which will undoubtedly complement the economist's with its relative inattention to a variety of questions—like historical development, the formation of individual and social tastes, and so on. The economic theorist's new formulation essentially provides a new metaphor for viewing the particular area of legal concern. But the economist's suggested metaphor is only one among many, and in attempting to understand, to analyze, and to aid in the development of the law, an approach which draws upon the variety of ways the several social sciences analyze human behavior is likely to be the most helpful and the most successful.