**Introduction: What is Law and Economics?**

* Before we jump into discussing and analyzing the ideas contained in the field known as law and economics, we must define what exactly the field of law and economics is and what it means when we use that term.
* What is **economics**?
* No doubt, you have heard a variety of definitions of economics in your time here as majors, all of which surely contain a great deal of truth but many of which emphasize different characteristics as essential.
* There will be different schools of thought that answer that question somewhat differently
* It is thus best to keep our definition very simple. Let us define economics, then, as merely the study of *purposeful* human action.
* In approaching the study of human behavior from an economic—or what is often called a “rational choice”—perspective, we seek to understand human behavior as a myriad of actions pursued in a rational manner by individuals, subject to the constraints that those individuals face.
* Some object to this approach on the grounds that it is wrong to treat human beings as rational. “How can you say this?!,” they demand; “We aren’t rational! We’re limited, we make mistakes all the time, we’re cursed with all sorts of inherent biases that taint our minds and obscure our understanding of the truth and the world around us!” If you are like me, your first inclination might be to say “Speak for yourself! Yes, *you* may be all of those things.” More fundamentally, however, in making this objection, critics of economics generally misunderstand the meaning which economists attach to the term “rational.”
* By it, we mean, as I say, that as social scientists who cannot directly observe the inner workings of other people’s minds, we must begin with the assumption that if individuals are repeatedly or systematically engaging in certain activities that they are doing so with some purpose and set ourselves the task of understanding just what that purpose is.
* When we do this, what we often find is that even the more unusual, bizarre, or disagreeable practices and institutions in which human beings have engaged have a certain logic behind them and that the diverse array of means by which human beings in different societies at different times have come to solve their problems are the product of their pursuits of certain basic values—life, liberty, property, trade, etc.—all subject to a unique set of constraints.
* In approaching our subject this way, we accord to our subject—that is: human beings—a certain respect. It does not always mean that we agree with the practices and institutions that they choose; we may find them infinitely frustrating. Science, however, is not about approval or disapproval but about the pursuit of knowledge and understanding. That is why we are here; to quote an old Latin phrase (which was my alma mater’s motto), “*rerum cognoscere causas*”—inquiring to know the causes of things. And we are here to apply economic theory and understanding to the causes and effects of the human institution of law. That brings us to our second question.
* What is the **law**?
* This is a question which, though it at first appears simple, is not necessarily so and which has invited a measure of disagreement.
* For many practical purposes, we can define laws as “rules, compliance with which is enforced by the state,” where the state is an institution that has established a monopoly on the legitimate use of physical force within a given geographical region.
* But what of laws which seem to emerge in places where there is no state and the burden of rule enforcement falls upon individuals more broadly, where tools such as ostracism are used in place of our modern toolkit of criminal punishments? What of private prisons in Ancient Greece? What of private arbitration in our own time? Are these not law?
* Is it the source of laws that makes them legitimate? Many advocates of common law—that is, judge-made law that has evolved through a social process and emerged over the course of centuries and which we will study in coming weeks—contend that it is the only true law and that legislation coming from parliaments and congresses is conceptually distinct from *true* law. If so, where does that leave what is now called “administrative law,” which is made neither in courts nor through a democratic process but by unelected bureaucrats? Can that be a legitimate source of law?
* These are difficult philosophical questions, many of which are beyond the scope of this course but which you should consider for yourself at some point, perhaps as we progress through this course.
* After all of this, the final question—what is law and economics(?)—seems easy by comparison: it is the application of economic theory to legal practices and institutions in primarily two ways:
* Using an economic way of thinking—that is, “maximization subject to constraints”—to understand the choice and creation of legal rules along with any consequences—intended or unintended—of those rules. We can think of this as “**the economics of the law**.”
* E.g. “What tradeoffs do judges face in exercising their decision making?” or “How does a change in the legal standards of liability affect firms’ decisions?”
* What broader effect do legal systems have on economic activity? This strain we can think of as “**What does the law have to do with the economy?**”
* E.g. “How do we explain why common law countries, on average, experience greater growth and prosperity than civil law countries?”
* In all cases, I want to inculcate you with an economic way of thinking about these issues. You will have the rest of your lives to go back to thinking about them the way that most people do, but if you will join me for fourteen weeks in thinking about these issues like an economist, it could clarify your thinking on them for the rest of your life.

Law and Economics: A Brief History

* Now that we have begun to conceptualize Law and Economics as a field, let us flesh it out a bit with a brief historical survey.
* The systematic application of economic analysis to the law is primarily a twentieth and twenty-first century phenomenon. It has precursors in the seventeenth, eighteenth, and nineteenth centuries, and we will explore those all next week. If you will forgive an anachronism, however, I will begin by giving you a brief survey of modern work on these issues so that you have some sense of where we are headed and can hopefully better appreciate those older works when you encounter them.
* That earlier generations of economists (or political economists) didn’t get as far in applying economic theory to analyzing law is by no fault of their own, as economic science and the toolkit that we use was not yet fully developed and at their disposal. It was only with the “marginal revolution,” as it is called, in the 1870s, and the development of what we call “price theory” or microeconomics by such economic luminaries as Austria’s Carl Menger, England’s Alfred Marshall, and France’s Leon Walras that important theoretical ideas took hold and could be applied in institutional analysis.
* Ideas such as the “subjective theory of value,” as it is called, supply and demand analysis, and the insight that it is marginal costs and benefits rather than total costs and benefits which govern decision making together gave rise to a new and uniquely economic lens through which to analyze human behavior. It is due to those contributions that we are able to adopt our framework of analyzing human behavior as rational maximization subject to constraints.
* Beginning in the 1930s, economists began to apply these tools to issues of competition and monopoly. In 1921, Frank Knight had published his landmark work, *Risk, Uncertainty, and Profit*, in which he set forth the model of perfect competition and distinguished it from monopoly or what came to be called “monopolistic competition.”
* By the 1930s, two unintended developments emerged from prior decades’ events.
* The first was that the Sherman Antitrust Act (the history of which we will further explore that subject later in the semester), passed in 1890 in order to benefit smaller businesses which struggled to compete with larger, more efficient ones but which had not been made as enforceable as its language would suggest was suddenly “given teeth” and saw more rigorous application by a new generation of legislators, judges, and advocates.
* The second was that Knight’s model of perfect competition, which he stressed was only constructed as an unrealistic ideal, a mere blackboard experiment, began to be treated by some economists as a prescriptive model to which they should seek to make the real world conform.
* The result of these developments was that economists took a new interest in antitrust law, which became the centerpiece of this burgeoning field of law and economics. Indeed, even twenty-odd years later when the *Journal of Law and Economics* was founded at the University of Chicago, debates over antitrust formed the core of the field and comprised the bulk of its research. The early years of that journal consist of one argument for the dangers of monopoly after another, matched by counterarguments challenging those concerns. This literature is so voluminous that I could literally have made this course about nothing else and still have covered only a fraction of it.
* At the same time, however, the economist Robert Hale began exploring the subject of contracts from an economic standpoint, a young Ronald Coase initiated another major strain of Law and Economics research when he published his article on “The Nature of the Firm” in 1937, and notable economists set foot down new roads in similar fashion, exploring themes related to taxation, corporate structure and governance, and intellectual property.
* In the 1960s, the field flourished with innovations. Coase again broke new ground with his article, “The Problem of Social Cost,” in 1961, and in the same year Guido Calabresi, a Yale law professor and later federal judge, initiated the economic analysis of torts. Both scholars’ works turned the focus of Law and Economics scholarship to the common law, revealing the potential of economics to do more than merely settle contemporary debates over regulatory policy but to understand the more fundamental elements of the Anglo-American legal tradition. And in 1968, when Gary Becker wrote his now famous article, “Crime and Punishment: An Economic Approach,” the notion that one could use economics to understand even the choices of criminals was greeted as radical and salacious, pushing the boundaries of what economics had to offer.
* Elsewhere, a tradition which is somewhat closer to home for us emerged as GMU economists James M. Buchanan and Gordon Tullock pioneered the field of Constitutional Economics. Constitutional Economics, though most closely related to the field of Public Choice, demonstrated that economic analysis could be applied even to our most fundamental legal framework—constitutions—and the rules within which legislators, bureaucrats, and judges must operate.
* On into the 1980s and the present, law and economics has been used to understand the relationship between legal systems and economic growth and applied to nearly all aspects of the law, from the core legal fields of contracts, torts, criminal law, and property to divorce and family law, international law, the laws of war, and, as always, generations of debate over competition and the relationship between the state and the market. We will address all of these subjects in the semester to come.

Review of Fundamentals and Price Theory

* Before we delve into the subject of law and economics this semester, I would like to spend today reviewing some fundamentals that will help you to appreciate the perspectives of law and economics and how to apply them. These fall primarily into two categories:
* Axioms and core concepts
* Price theoretic models
* Some of this will be derived from your readings this week from Richard Posner and from George Stigler; other aspects will not be, so please note them carefully
* Axioms. First, what is an axiom? In philosophy, an axiom is a term which can only be defined by reference to itself. It is, to quote one philosopher, “the identification of a primary fact of reality, which cannot be analyzed, i.e. reduced to other facts or broken into component parts… It is the fundamentally given and directly perceived or experienced, which requires no proof or explanation, bot on which all proofs and explanations rest.” (Rand, *ITOE*, pg. 55) For instance, one cannot define the concept “existence” without using the term “is” or some variant thereof. It is too fundamental. The same is true of “consciousness,” the meaning of which is taken as given without challenge, or “identity.”
* Economics has its own axioms, though they are not the same as those of philosophy. They are more derivative. Economics, as with all social sciences, is downstream from philosophy. Philosophy asks things like “Where are you (meaning in what kind of universe)? How do you know it? What should you do about it?” Ultimately, political philosophy takes the answers to those questions and attempts to answer questions such as “What kind of society should man aspire to? What does it mean to be free? What are political rights? Do they matter?”
* Philosophy gets us as far as defining these concepts, but economics inherits them as they are and does not delve back into these conceptual debates. We do not spend our time in economics debating what is or is not a human right. Nonetheless, these concepts are particularly relevant in a course on Law and Economics, as we will be perpetually discussing things like property rights. As we do, we are reminded that economics evolved from the study of moral philosophy—Adam Smith was a professor of moral philosophy—but that, in order to be both scientific and constructive to human understanding and, human life, can be neither propaganda nor totally independent of moral concepts (such as “rights”) but rather must be a descriptive science that depends upon and uses certain moral concepts in describing cause and effect relationships.
* So what are the axioms in economics? I offer a few:
* Reason
* Value
* Choice
* Production
* Consumption
* Trade
* Force
* Rights
* Freedom
* Unlike philosophical axioms, we can define economic axioms thanks to philosophy, but when we are practicing economics we do not spend our time—as we will not in this class—on conceptual debates. We inherit them as given.
* Beyond axioms, what other core economic concepts will we require? Those mentioned by Posner
* The Law of Demand
* First: Ceteris paribus, when you increase the price of a good or service, people will not demand more of it and they are likely to demand less of it.
* Second: “A given change will usually lead to a larger change in the quantity consumers buy, the longer the price change has been in effect.” – George Stigler (*The Theory of Price*, pg. 25)
* Opportunity cost
* Always measured not in monetary terms but in terms of the next best alternative use of the same resources
* All costs are opportunity costs!
* Tendency of resources to gravitate toward their most valued uses
* Externality (Good and bad)
* Definition: effects (both costs and benefits) of human action which are not fully borne by the acting individual
* Negative: Alcohol, fire hazards, smoke from a chimney, etc.
* Positive: Bees to orchards, businesses improving their storefronts or investing in infrastructure, wearing cologne/perfume, effects of home improvements on neighbors’ property value, etc.
* Equilibrium
* Three views of equilibrium
* Markets and human behavior are at equilibrium until disturbed from that equilibrium but will then tend back toward it with greater (neoclassical) or less (Keynesian, New Keynesian, Post Keynesian) rapidity
* Markets and human behavior are in a “continuum of equilibrium,” at all times being subject to the maximizing efforts of individuals on both the demand and supply sides (New Classical, Chicago Becker/Stigler)
* Markets and human behavior are best thought of as in a constant state of disequilibrium, with entrepreneurs driving a dynamic pursuit of equilibrium that never or only fleetingly attains
* Efficiency
* As with equilibrium, there are different concepts of efficiency that lead to differing perspectives on legal rules and institutions.
* You have been exposed to two of these in your readings this week:
* The first concept of efficiency, offered by Richard Posner, defines it as a state of affairs which maximizes the value of social resources, typically as measured by some aggregate variable such as GDP.
* What are the implications of this view of efficiency for law and legislation? Two possibilities:
* Legislation is an instrument that we can use to improve upon efficiency by resolving market failures and pursuing wealth-improving policies
* Legislation can diminish efficiency by destroying wealth and propagating both market and government failures
* The second, offered by George Stigler, contends that all durable social institutions are efficient or else they would cease to exist as they are. In this view, the state of affairs which exists at any given moment is the result of the maximizing efforts of all parties involved and that as a result, though we may normatively disagree with that state of affairs, we cannot deny its efficiency. If the benefits to changing the existing state of affairs exceeded the costs of doing so, people would change. That they have not is proof that, at least for this moment in time, *whatever is is efficient*. In fact, by that definition, *everything* is efficient!
* What are the implications of this view of efficiency for law and legislation?
* As implied in my introduction to this class, I will often tend toward the latter, Stiglerian definition because I want to highlight to you how legal institutions, rules, and practices are the result of human choice and the pursuit of human values, even when that value is not the maximization of social wealth or utility. However, you are welcome to use either in discussions and writings in this class so long as it is clear to which definition you are referring.
* Price Theory
* Some of the basics of this have been touched upon in our discussion of these core concepts
* I will assume knowledge of most or all of the necessary price theory for this class, but I have posted some price theory works online for your reference if necessary
* For the most part, this course will not rely upon graphical or quantitative representations except where necessary, but for that very reason it is important to review them briefly so as not to allow the price theoretic insights to drift away from us.
* Core models
* Consumer choice
* Demand (Price elasticity of)
* Supply
* Monopoly
* Price controls

Discussion Questions

* Whose definition of efficiency do you find most instructive? Most productive to understanding?
* Does the Stiglerian view of efficiency diminish the role of economists? Does it require us to agree with or “rubber stamp” the status quo?
* What other practices or institutions which are generally frowned upon could be reframed as efficient in the Stiglerian sense, and how?