ECONOMIC EFFICIENCY IN ECONOMIC ANALYSIS OF LAW

Tomasz Famulski
Absolwent kierunku: Prawo
Wydział Prawa i Administracji
Uniwersytetu Jagiellońskiego w Krakowie

Abstract
The aim of the article is to identify the category of economic efficiency on the grounds of L&E. According to the primary thesis of L&E economic efficiency is a fundamental legal value. The study discusses said thesis. On one hand, the controversy surrounding the thesis stem from lack of its unequivocal understanding. On the other, law has been functioning for centuries, while the question of its economic efficiency has only been raised for a few decades. Fundamental value, which has always been associated with law, is justice. It follows that the issue of various approaches to the relation between economic efficiency and justice in L&E is considered. Critical analysis of the literature allows to formulate arguments for and against each of these values in enacting and enforcing the law. Significant differences in various approaches to this matter are identified. Simultaneously, the assumption that efficiency is a value realized in the law beside justice is considered to be correct. The issue raised is important from the practical point of view. A theoretical consensus would support formulating a model, which would allow assessment of legal regulations based on criteria of economic efficiency and justice.

Keywords: economic efficiency, Law & Economics, economic analysis of law, justice.

JEL Class: D61, D63, K00.
INTRODUCTION

Economic analysis of law (Law & Economics, L&E) is a relatively new scientific movement, which began in the second half of the 20th century in the United States. It is in the US where L&E is developing most rapidly. Generally speaking, the originality of economic analysis of law is based on the fact that the proponents of the movement use methodology of economics to research every branch of law. The issue of economic efficiency of law, which is the subject of this analysis, is a very important research area in Law & Economics. The aim of this study is to identify the category of economic efficiency on the grounds of L&E.

According to the primary thesis of Law & Economics, economic efficiency is a fundamental value of law. This article discusses said thesis. On one hand, the controversy regarding the efficiency thesis stems from lack of its unequivocal understanding. On the other hand, law has been functioning for centuries, while the question of its economic efficiency has only been raised in the second half of the 20th century (along with the birth of the scientific movement of L&E). Fundamental value, which has always been associated with law, is justice. It follows that the issue of various approaches to the relation between economic efficiency and justice in L&E is considered in the article. It is assumed that economic efficiency is a value realized in law beside justice. The reflections head toward formulating arguments both for and against the dominance of one of the values considered in the practice of enacting and enforcing the law. Thereby, the reflections are important from the practical point of view.

The article is a theoretical study. The method of critical analysis of literature has been employed. Both Polish and foreign (mostly American) literature is cited. Comparative approach dominates the analysis. It is worth noting that the subject under consideration has little recognition in Polish literature.

1. OUTLINE OF LAW & ECONOMICS

The existence of relations between law and economy is undeniable. Countless examples of such relations can be named. Civil and business law develops as an answer to ever-changing economic reality. Financial and labor law have a great impact on the economic system of a country. Even the economic system itself can be sanctioned constitutionally. Functioning of a legal system is inevitably connected with the existence of public institutions, which is also not economically indifferent. These relations between law and economy are not surprising, because both of these human endeavors often concern the same
situations, albeit from a different perspective. For instance, legally a transaction almost always takes a form of a contract, but from an economic perspective it can be seen as allocation of goods. Establishing minimum wage puts a certain legal obligation on the employer, but on the other side is also an incursion in the labor market. From today’s perspective, the marriage of two scientific disciplines that correspond with law and economy, that is jurisprudence and economics, seems inevitable.

It has been pointed out in literature that reflection upon the relations between law and economics has been present in philosophical and political writings for centuries, for instance in the works of Niccolo Machiavelli, Thomas Hobbes or David Hume [Beldowski and Metelska-Szaniawska 2007: 52]. However, it was not until late 1950s that Law & Economics would constitute a scientific (jurisprudential) movement. First landmark is the start of publication of The Journal of Law and Economics, associated with a group of scholars working at University of Chicago. In 1961 two articles that would become seminal for L&E were published: The Problem of Social Cost by Ronald Coase [1961] and Same Thoughts on Risk Distribution and the Law of Torts by Guido Calabresi [1961]. Another landmark publication was Economic Analysis of Law by Richard Posner. This book had a groundbreaking effect on the movement due to the fact that it equipped legal scholars with relatively simple economic tools for economic analysis, and contained reflection on various areas of law from economic point of view. It also presented what could be called underlying philosophy of Law & Economics, particularly the efficiency thesis. It is worth noting that the name of the jurisprudential movement present in the Polish literature stems from this book (ekonomiczna analiza prawa). It is roughly interchangeable with the Anglophone term ‘Law & Economics’.

The development of Law & Economics has been dynamic, especially at the place of its birth, i.e. the United States. Several of the most influential and prominent legal scholars are proponents of said movement, with Richard A. Posner being the most cited legal scholar of all time. Other frequently cited academics associated with Law & Economics are Guido Calabresi, Richard A. Epstein, Cass R. Sunstein, Steven Shavell, Robert D. Cooter and A. Mitchell Polinsky [Shapiro 2000: 424]. The movement also gained recognition in mainstream economics, going as far as to grant the Nobel Memorial Prize in Economics for some of its proponents. In 1986 James M. Buchanan received the prize for work on public choice theory (subdiscipline related to Law & Economics). Ronald H. Coase has been awarded in 1991. The following year the pioneer of research of non-market behavior (including criminal activity), Gary S. Becker, became the laureate [Jasiński 2012: 110, 128, 131].

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1 The book has many editions, the most recent being [Posner 2014].
Economic analysis of law could be defined in general as an application of methods of economic sciences to research legal rules and legal institutions – how they come to existence, how are they structured, what processes are they related to, and how do they affect reality [Kornhauser 2015]. Law & Economics not only perceives law as one of the variables of the economic system, but also engages in research of the branches of law which may seem distant from economic issues. It follows that the subject of economic analysis of law is not only business or financial law, but also criminal or constitutional law. The fact that Law & Economic makes virtually every branch of law its subject is its distinguishing feature. Proponents of the movement research law, and its changes in particular, as a factor which influences economic reality. Legal rules and institutions are treated not as some fixed points outside of economic system, but rather as economically relevant choices which should be explained from the economic point of view [Mackaay 2000: 65].

There are several fundamental concepts underlying the economic analysis of law. Application of these concepts to particular branches of law constitutes the essence of Law & Economics approach. Most important of these are rational choice theory and its relation – utility maximization theory, the Coase theorem and the issue of transaction costs, bargaining theory, and the efficiency of law [Belkowski and Metelska-Szaniawska 2007: 52]. The latter concept is often expressed in the form of the so called efficiency thesis.

2. EFFICIENCY THESIS

The efficiency thesis of the economic analysis of law has two aspects: descriptive and normative. Descriptively, the efficiency thesis states that legal rules are, in fact, economically efficient. Normatively, the thesis states that legal rules ought to be efficient [Kornhauser 2015]. Literature provides even a stronger claim, namely one that economic efficiency ought to be the only purpose of law [Stelmach et al. 2007: 17]. Both aspects of the efficiency thesis prove to be controversial and give rise to several issues.

The descriptive claim may seem ambiguous, because it is not clear whether it means that legal rules induce economically efficient behavior or that the law itself is efficient. It would follow from the latter understanding that the content of law is identified by its efficiency and, conversely, that an inefficient rule

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2 Due to the fact that the modern Law & Economics movement came to existence in the common law world, these claims – when first made by Richard A. Posner – related to common law. However, since then economic analysis of law has been applied to continental law. The efficiency thesis can therefore be perceived as a philosophical claim about law in general.
cannot be a legal rule. However, the debate concerning the method of identification of the content of law is almost as old as philosophy itself, and neither does economic analysis of law make a strong claim in this matter (the defense of this particular claim has never been its primary concern), nor is the acceptance of the descriptive aspect of the efficiency thesis crucial to conducting economic analysis of law [Kornhauser 2015]. In contrast, the normative aspect of the efficiency thesis is essential to economic analysis of law and, although universally accepted among scholars, gives rise to a different kind of controversy – namely, what should be understood as ‘efficient’

Jerzy Stelmach, Bartosz Brożek and Wojciech Zaluski distinguish four ways of defining economic efficiency in economic analysis of law [Stelmach et al. 2007: 26]. These are: welfare maximization, Pareto efficiency, Kaldor-Hicks efficiency, and marginal analysis. A noteworthy addition to this enumeration would be an improved version of Kaldor-Hicks efficiency proposed by Richard O. Zerbe.

Efficiency understood as welfare maximization stems from an ethical position of utilitarianism. Utilitarianism is a belief which claims that actions should be judged by their results (this view is called consequentialism⁴), and that actions considered to be good should maximize social utility (hence the name). In this context the phrases ‘social utility’ and ‘welfare’ can be used interchangeably. If efficiency is defined as welfare maximization, efficient law should maximize welfare⁵. From a number of proposed legal solutions, the one that maximizes welfare the most should be considered best. Although seemingly simple, this understanding of efficiency has a significant drawback. Despite many efforts by moral philosophers throughout the ages, the criterion of utility is still abstract and vague, and it follows that practical application of this understanding of efficiency is problematic. If the lawmaker would like to introduce legal regulation with this sense of efficiency in mind, he would have to take the whole society’s preferences under consideration, and, what is more, all members of that society would have to be able to define those preferences.

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³ It should be noted that efficiency in context of this article always means economic efficiency. In jurisprudence the efficiency of a legal rule is most often understood as a successful realization of the lawmaker’s intention by that rule.

⁴ An opposite stance in ethics is deontology, i.e. a belief that actions should be judged on the basis of following a certain rule, regardless of the outcome of the action.

⁵ An important difference between continental and common law systems ought to be considered in this context. While common law is based on precedent (i.e. judge-made law), continental systems are based on statutes. Under common law, it would seem enough for the court’s decision to be efficient. Under a continental system, even if the regulations provided in a statute seem efficient, there is still the matter of court’s interpretation of that regulation. Perhaps for the continental systems another version of the efficiency thesis could be formulated, e.g. ‘interpretations of statutes ought to induce efficient realization of those statutes’.
Only in this manner would the lawmaker be able to judge which of the proposed legal solutions maximize social utility. Of course such preferences could be approximated, but one can never be certain whether the proposed regulations actually does maximize welfare.

Efficiency understood in the Pareto sense avoids the problem of comparing preferences. A given situation is improved in the Pareto sense, when the change in social reality does benefit at least one person (increases that person’s utility), and does not worsen the state of any other person (does not decrease utility of any other person). A situation is effective in the Pareto sense, when no more such improvements can be made [Stelmach et al. 2007: 30–31]. When applied to economic analysis of law, this understanding of efficiency would call for such legal regulations that make improvements in the Pareto sense and head toward Pareto efficiency. However, such situations are extremely rare in reality. Usually, a change in law results in some benefits for a certain group of people and some losses for another group. It is in the nature of legal regulations that creating a right for one person also creates an obligation for another person – an obligation mirrors a right. However, it could be said that functioning of public services, e.g. healthcare, public schooling, benefits all members of society, and therefore is an improvement in the Pareto sense, but the issue seems more complicated when financing of those services (which in most cases would come from taxation) is considered. Other example concerns contract law. The proponents of economic analysis of law claim that every voluntary contract, if the subject of said contract is valued by the parties in a rational way, is efficient in the Pareto sense. To explain this view Law & Economics uses a game – theoretic concept called bargaining theory, which supposedly proves that contracts are mutually beneficial. Therefore, contract law which encourages free and rational exchange of goods and services would be efficient in the Pareto sense.

Another concept of economic efficiency, similar to Pareto efficiency, is efficiency in the Kaldor-Hicks sense. A given situation is improved in the Kaldor-Hicks sense, when the change in social reality does benefit at least one person (increases that person’s utility), and even though it may worsen other person’s state (decrease that person’s utility), the benefit of the first person is greater than the loss of the other person, so that there is a possibility of the loss being compensated and the first person still having his or hers utility increased. A situation is effective in the Kaldor-Hicks sense, when no more such improvements can be made [Stelmach et al. 2007: 36–37]. The supposed loss compensation is understood as an abstract concept, not an obligation. It follows that law efficient in the Kaldor-Hicks sense would not have to create such obligation, only the conditions for Kaldor-Hicks improvements. It is worth

6 For further insight in bargaining theory, cf. [Stelmach et al. 2007: 32–35]
noting that efficiency understood in the Kaldor-Hicks sense appears to be easier to achieve than Pareto efficiency⁷.

A different understanding of economic efficiency is based on marginal analysis. Marginal analysis is a method of inquiry into relations between costs and benefits of an activity. An activity may require costs to be incurred, and result in benefits. As long as benefits exceed costs, the activity is efficient. However, at some point, the costs may start to exceed the benefits. At this point an activity can no longer be called cost-efficient. For instance, crime prevention is costly, but it results in certain benefits for society. However, a complete elimination of any criminal activity would be so expensive that its costs would exceed its expected benefits. The purpose of marginal analysis is to locate a point at which the use of resources is as high as possible, but still results in benefits. Going beyond that point (for example spending more money on crime prevention, when there is only little increase in social benefit of it to be expected) is understood as inefficient in marginal analysis sense [Stelmach et al. 2007: 37–38].

An interesting proposition concerning the understanding of economic efficiency in the context of economic analysis of law has been put forth by Richard O. Zerbe. Zerbe’s aim is to propose ‘a definition of efficiency that is workable in practice, theoretically sound, and ethical’ [Zerbe 2001: 1]. Zerbe’s concept of efficiency is based on Kaldor-Hicks understanding of efficiency, albeit with several adjustments made to include values which Zerbe perceives to be missing from the Kaldor-Hicks efficiency. He argues that there ought to be values taken into consideration and proposes a new measure, called KHZ, which is supposed to be Kaldor-Hicks efficiency adjusted for values. In response to abundant criticism toward normative economic standards, Zerbe aims to propose a measure that would provide better information about the will of the public. To achieve this purpose, Zerbe presents seven axioms for the new measure: (1) it is to be based on the Kaldor-Hicks sense of efficiency, (2) its purpose is to provide the decision-maker with information, not to determine the right decision, (3) psychological discoveries are taken into account – losses and gains are to be seen subjectively and as changes from the status quo position, (4) three conditions about information are established: (a) the measure should not require information that will never be available, (b) better-informed decisions are preferable to less-informed ones, (c) utility, as it is unmeasureable, is considered to be unavailable information, (5) three conditions about costs of change are established: (a) transaction costs are to be included in the measure⁸, (b) the costs of

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⁷ In addition to that, every Pareto efficient situation is also efficient in the Kaldor-Hicks sense, but not the other way round.

⁸ Transaction costs are the costs that surround making a transaction. In the aforementioned article, Ronald H. Coase has observed that apart from paying the actual price for a good or
of enacting a rule are to be disregarded from the point of view of that new rule’s efficiency, (c) also the costs of hypothetical distributional changes required for compensation test are not to be counted\(^9\), (6) two assumptions about values are to be made: (a) the measure ought to include any value or good for which there is willingness to pay\(^{10}\), (b) values appearing to be missing the cost-benefit analysis are in fact included as transaction costs; also income distribution, fact of compensation (or lack thereof) and the regard for others are defined as economic goods, (7) existing pattern of rights should be understood as an influence on economic efficiency \[\text{Zerbe 2001: 17–18}\].

This highly sophisticated model of efficiency provides a certain insight into two issues. Firstly, it can be seen that the problem of defining efficiency has given rise to numerous criticisms of the normative economic standard (e.g. the question of utility maximization, controversy about the human perception of losses and gains). Secondly, it indirectly suggest that there is another problem to be addressed. Namely, why is it that despite the fact that legal system have existed for centuries, the question of efficiency of law have only started to be addressed in the second half of the 20\(^{\text{th}}\) century? A provisional answer could be that law has always been expected to realize value other than efficiency, that value being justice.

### 3. VARIOUS APPROACHES TO ECONOMIC EFFICIENCY AND JUSTICE IN ECONOMIC ANALYSIS OF LAW

It is extremely difficult to say anything definitive about the relation between economic efficiency and justice. The issue seems even more complicated when one realizes numerous problems with defining these concepts separately, as the previous chapter depicts in the case of efficiency. Nevertheless, scholars put forth a variety of differing views on the issue. One must bear in mind that efficiency and justice will not be the only concepts addressed in such

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\(^9\) Compensation test is an inquiry conducted to determine whether a given action will lead to an outcome efficient in the Kaldor-Hicks understanding of efficiency.

\(^{10}\) Willingness to pay is the maximum price a potential buyer would be willing to pay for a good, while being capable of actually paying said price (strictly speaking, the buyer must have enough money to pay for what he or she is willing to pay). This measure is different than simple preference (or expected utility), because people can prefer (and expect utility from) good they cannot afford.
deliberations. It often happens that only one of the ways of understanding efficiency (e.g. welfare maximization) is discussed, and conversely, the issue of justice is placed in a wider context of morality.

Jerzy Stelmach, Bartosz Brożek and Wojciech Załuski criticize the notion that economic efficiency ought to be the only purpose of law. They argue that following particular concepts of efficiency may lead to breaking of certain legal and ethical principles. For instance, welfare maximization could justify involuntary transfer of goods. This allocation would maximize welfare, but would be contradictory to the legal principle of freedom of contract [Stelmach et al. 2007: 40–41]. Similar argument was raised by Ronald Dworkin. Dworkin imagines a benevolent tyrant, who would forcefully transfer goods among his subjects in order to maximize their wealth, but this would simultaneously violate their rights and liberties [Dworkin 1980: 197]. Furthermore, a breach of a contract may be preferable to fulfilling it on grounds of maximizing social utility, and therefore lead to violating the principle of pacta sunt servanda. The same grounds would also justify immoral preferences, while it is intuitive to expect law to forbid and punish such behavior. Finally, the authors point out that Pareto efficiency lacks a criterion of distributive justice (and does not justify the redistribution of resources), but also is often seen as a necessary condition for just distribution. Efficiency may also conflict with commutative justice [Stelmach et al. 2007: 44–45].

Different perspective is offered by Robert Cooter. Cooter distinguishes between corrective and distributive justice. This distinction allows him to formulate a conclusion that private law is an ineffective way for distributive goals and therefore distributive justice is irrelevant to private law. It is relevant from the point of view of tax law and social welfare law, since these branches are effective for distribution [Cooter 2005: 18–20]. As for corrective justice, Cooter states that it could be argued that wealth maximization is a social goal of such importance, that it is embodied in social norms (and, in turn, in the sense of justice). He also provides less materialistic explanation, pointing out that many moral values, like concern and respect for others, demand the same requirements as efficiency does. For instance, people should be cautious when the cost of precautions is lower than the cost of reducing risk for other people. It is exactly what efficiency requires, and furthermore, it is how tort law functions. This allows Cooter to conclude that corrective justice and economic efficiency actually converge in social norms and law [Cooter 2005: 21–23].

A strong case for welfare maximization has been made by Louis Kaplow and Steven Shavell. They argue that legal regulations ought to be evaluated only on the basis of welfare economics, with no room for evaluation based on
fairness\textsuperscript{11}. This is due to the fact that fairness-based assessment of legal rules does not exclusively depend on the impact of regulations on individual’s well-being. It follows that choice of a rule based on fairness may leave individuals worse off (reduce their welfare). The authors argue that in some important cases fairness-based choice even makes every individual worse off. This happens when individuals are symmetrically situated. Since it is in the nature of welfare maximization to increase social utility, every rule that would differ from welfare-based rule would necessarily reduce everyone’s welfare in comparison to the welfare-based rule. Kaplow and Shavell also argue that acceptance of Pareto efficiency, albeit difficult to realize, is preferable because it leads to disregarding the notions of fairness (which, in turn, may lead to situation that welcomes the possibility of reducing individual’s welfare) [Kaplow and Shavell 2002: 52–56].

However, welfare maximization meets criticism, especially from opponents of Law & Economics in general. The issue of immoral preferences has already been raised. Another problem is the assumption that desires and opportunities are independent, while it may be the case that opportunities influence desires. Welfare maximization fails to take other psychological factors into account. For instance, the phenomenon called the endowment effect, which describes human tendency to value more what one already possess, or the sour grapes effect, which, conversely, describes human tendency to value less goods that are either way unavailable. Law & Economics may focus too much on measurable variables, while failing to take into account unmeasurable motivations for human actions (e.g. empathy). Opponents of welfarism propose alternatives to utility as a measure, for instance the concept of primary goods, which are goods that ought to be desired by all people (like health, intelligence, civil and political rights, wealth, social bases of self-respect etc.) [Kerkmeester 2000: 387–389].

An alternative to social utility has been proposed by the pioneer of Law & Economics, Richard A. Posner. Instead of welfare maximization, Posner opts of wealth maximization. Wealth is understood in this case as value of all goods expressed in monetary terms. The value of a good is assessed by willingness to pay (see fn. 10). Efficient situation takes place when a good is allocated to the person who has the highest willingness to pay for that good. Posner believes that such measure reflects moral intuitions in a better way, and that conventional virtues (honesty, dependability) can be derived from the principle of wealth maximization. It has been pointed out that, in essence, wealth maximization is identical to Kaldor-Hicks efficiency (situations efficient in the Kaldor-Hicks sense are also efficient according to the principle of wealth maximization).

\textsuperscript{11} For the purpose of this article the term ‘fairness’ can be treated as synonymous with justice. Such usage is strongly grounded in modern political philosophy. Cf. [Rawls 2001].
In Posner’s view, the advantage of wealth maximization is that it promotes production, in contrast to utilitarianism, which in his view promotes consumption. What is more, wealth maximization is supposed to increase utility more than utilitarianism could directly. Willingness to pay constitutes a better measure than utility, due to the fact that it is expressed in monetary terms, whereas there is no satisfactory unit for utility [Mathis 2009: 145–157].

Contrary to Posner’s belief, Bruce Chapman argues that the pursuit of wealth can be an impediment for increasing welfare. Chapman points out that exchanges which maximize wealth can lead to social loss. This is not a problem when one assumes Pareto efficiency (the losses are compensated), but poses a problem when Kaldor-Hicks efficiency (and, therefore, no actual compensation) is assumed. If such a transfer is legally mandated (e.g. by a court order), it seem imaginable that a series of such allocations can actually make everyone worse off [Chapman 2005: 9]. Chapman also argues that the concept of wealth is ambiguous, because in reality wealth is not the only thing that people pursue, but rather they pursue different things which can all group under the word ‘wealth’ [Chapman 2005: 18]. In light of this observation Chapman accentuates the importance of social consensus, morality, and freedom of choice, which need to be supported by legal regulations, and rejects economic efficiency as a normative foundation of law [Chapman 2005: 23–24]. Walter J. Schulz goes even further and states that efficient trade is impossible without certain moral conditions. Schulz attempts to enumerate said conditions, which include property rights, a right to true information, a right to welfare, a right to autonomy, and liberty [Schulz 2001: 99–104]. In Schulz’s view morality precedes efficient trade, and, therefore, any maximization, while in Posner’s view moral rules are derived from the principle of wealth maximization.

It can be observed that the question of the relation between efficiency and justice is unavoidably intertwined with morality. It is worth noting that this entanglement is not only caused by the fact that justice is a moral issue, but also, somewhat surprisingly, by the fact that assuming a certain sense of efficiency turns out to be morally relevant.

CONCLUSION

The attempt to indentify the category of economic efficiency on grounds of the scientific movement of economic analysis of law leads to a general conclusion that the issue is complex and that literature does not provide a definitive solution. Critical analysis of literature allows to state that in light of the absence of one widely accepted concept of economic efficiency in general, there is also no commonly accepted understanding of economic efficiency in
Law & Economics. However, it must be noted that proponents of economic analysis of law frequently assume two of the senses of efficiency, namely: (1) welfare maximization, (2) Kaldor-Hicks efficiency\(^{12}\). There is a variety of stances toward the primary thesis of L&E which states that economic efficiency is a fundamental value of law. The study of literature reassure the view that economic efficiency cannot contradict justice (or, in wider sense, morality), due to the fact that justice is considered to be the value that is supposed to be realized by law. The review of arguments both for and against the dominance of one of these values in practice of enacting and enforcing law unveils significant differences in opinions on that matter. The issue of the relation between economic efficiency and justice in Law & Economics remains open, and further theoretical discourse must be considered desirable, particularly from the practical point of view. Achieving a consensus on theoretical grounds would support formulating a model of assessment of both existing and proposed legal regulations. Such model would be based on a criterion of economic efficiency, but would also take justice into consideration. Such a task seems like challenge for Law & Economics when one realizes that the concept of justice is equally or even more complex than that of economic efficiency.

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\(^{12}\) This accounts also for Posner’s wealth maximization principle which in essence is considered to be Kaldor-Hicks efficiency.
Streszczenie

Słowa kluczowe: efektywność ekonomiczna, Law & Economics, ekonomiczna analiza prawa, sprawiedliwość.