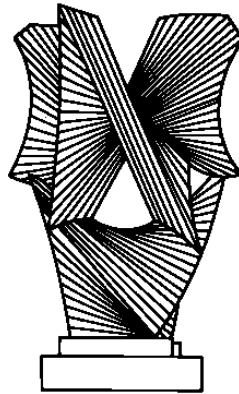


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VALUES AND CONSEQUENCES:  
AN INTRODUCTION TO ECONOMIC ANALYSIS OF LAW

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# Values and Consequences: An Introduction to Economic Analysis of Law

*Richard A. Posner*<sup>1</sup>

I am going to give a very brief, thumbnail sketch of economic analysis of law, and then focus on just two uses of the analysis, and in doing so try to give you a bit of its flavor. The first use is to make law simpler to understand and evaluate; and the second is to press you to defend your values.

That there is a relation between economics and law has been known for an awfully long time, at least since Hobbes's discussion of property in the seventeenth century. But until very recently, the relation received focused attention only in relation to a handful of legal fields, mainly antitrust and public utility regulation, that dealt explicitly with competition and monopoly, which as early as the 1930s were receiving the sustained and sophisticated attention of leading English and American economists. (Competition and monopoly had received the attention of economists since Adam Smith; hence the qualification "sustained and sophisticated.")

In retrospect, an economic literature dealing with other fields of law, notably Robert Hale's work on contract law, which also dates from the 1930s, can be identified. But even after the *Journal of Law and Economics* commenced publication—at this law school, naturally—in 1958, the "law and economics" movement, if discernible at all, would have been associated primarily with problems of competition and monopoly, although occasional forays had been made into taxation (Henry Simons) and corporations (Henry Manne), even patents (Arnold Plant), and if one went back to the eighteenth century there was Bentham's largely forgotten utilitarian—essentially, economic—analysis of crime and punishment. It was not until 1961, when Ronald Coase's article "The Problem of Social Cost" was published,<sup>2</sup> and at about the same time Guido Calabresi's first article on torts,<sup>3</sup> that an economic theory of the common law could be glimpsed. When Gary Becker published his article "Crime and Punishment: An Economic Approach,"<sup>4</sup> reviving and refining Bentham, it began to seem that perhaps no field of law could not be placed under the lens of economics with illuminating results. And within a few years, sure enough, papers on the economics of contract law, civil and criminal procedure, property,

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<sup>1</sup> Chief Judge, United States Court of Appeals for the Seventh Circuit; Senior Lecturer, University of Chicago Law School. This is the text of a Coase Lecture given at the University of Chicago Law School on January 6, 1998.

<sup>2</sup> *3 Journal of Law and Economics* 1 (1960 [but actually published in 1961]).

<sup>3</sup> Guido Calabresi, "Some Thoughts on Risk Distribution and the Law of Torts," *70 Yale Law Journal* 499 (1961).

<sup>4</sup> *76 Journal of Political Economy* 169 (1968).

consumer protection, and other areas new to economists had appeared and the rough shape of the mature field was discernible. Later, books and articles would extend the economic analysis of law into such fields as employment, admiralty, intellectual property, family law, legislation, environmental law, administrative law, conflict of laws, and judicial behavior; and this is only a partial list. The field has developed to the point where the dean of the Yale Law School, a critic of the field, said recently: “The law and economics movement was and continues to be an enormous enlivening force in American legal thought and, I would say, today continues and remains the single most influential jurisprudential school in this country.”<sup>5</sup>

The economic analysis of law, as it now exists not only in the United States but also in Europe, which has its own flourishing law and economics association, has both positive (that is, descriptive) and normative aspects. It tries to explain and predict the behavior of participants in and persons regulated by the law. It also tries to improve law by pointing out respects in which existing or proposed laws have unintended or undesirable consequences, whether on economic efficiency, or the distribution of income and wealth, or other values. It is not merely an ivory-towered enterprise, at least in the United States, where the law and economics movement is understood to have influenced legal reform in a number of important areas. These areas include antitrust, the regulation of public utilities and common carriers, environmental regulation, the computation of damages in personal injury suits, the regulation of the securities markets, the federal sentencing guidelines, the division of property and the calculation of alimony in divorce cases, and the law governing investment by pension funds and other trustees, and to have been a significant factor in the deregulation movement and in free-market ideology generally. Most major and many minor law schools have one or two full-time economists on their faculty; a number of law professors have Ph.D.’s in economics; there are six scholarly journals devoted to economic analysis of law, with a seventh on the way; the use of economists as expert witnesses has become conventional in a range of important fields; judicial opinions refer to economic concepts and cite economic books and articles; and a number of federal judges, including a Justice of the Supreme Court (Stephen Breyer), are alumni of the law and economics movement. Economic analysis of law is generally considered the most significant development in legal thought in the United States since legal realism petered out a half century ago.

Noneconomists often associate economics with money, capitalism, selfishness—with a reductive, unrealistic conception of human motivation and behavior, a formidable mathematical apparatus, and a penchant for cynical, pessimistic, and conservative conclusions. It earned the sobriquet of “the dismal science” because of Thomas Malthus’s thesis that famine, war, and sexual abstinence were the only ways in which population and food supply could be equilibrated. The essence of economics is none of these things,

<sup>5</sup> Remarks of Anthony T. Kronman, *The Second Driker Forum for Excellence in the Law*, 42 *Wayne Law Review* 115, 160 (1995).

however. The essence is extremely simple, although the simplicity is deceptive; the simple can be subtle, can be counterintuitive; its antithesis is “complicated,” not “difficult.”

Most economic analysis consists of tracing out the consequences of assuming that people are more or less rational in their social interactions. In the case of the activities that interest the law, these people may be criminals or prosecutors or parties to accidents or taxpayers or tax collectors or striking workers—or even law students. Students treat grades as prices, so that unless the university administration intervenes, unpopular professors, in order to keep up their enrollments, will sometimes compensate students for the low perceived value of the course by giving them higher grades, that is, by raising the price that the professor pays for the student.

I said that the tracing out of consequences is subtle as well as simple, and here is an example. Have you heard of the spendthrift trust? That is a trust, very common, indeed standard, in which the trustee is forbidden to pay out any of the money or other property in the trust to the creditors of the trust’s beneficiaries. The law will enforce such a restriction, yet it has seemed to many students of the law a fraud on creditors; for the trust beneficiary, assuming that his whole wealth is in the spendthrift trust, can borrow all he wants, spend what he borrows, and not be forced to repay the lenders. But if you think about this for a moment, you’ll be driven to the opposite conclusion—that, provided the provision preventing creditors from reaching into the trust is not concealed, a spendthrift trust *limits* borrowing by the trust beneficiary, because he can’t offer security to the lender. And the next step in the analysis is to see how increasing the rights of debtors in bankruptcy, far from causing an avalanche of reckless borrowing, could reduce the amount of borrowing, and so the incidence of bankruptcy, by causing lenders to make smaller loans to risky borrowers. So lenders may oppose easy bankruptcy not because they fear there will be more defaults, but because they fear a reduction in the volume of loans. To see this, imagine how many, or rather how few, loans there would be if borrowers had no obligation to repay. Notice also how creditors are as hurt by excessively stringent as by excessively lenient bankruptcy rules: if creditors had the legal right, as under ancient Roman law, to carve up a defaulting borrower into as many pieces as there were creditors, most people would be afraid to borrow. Can you see now why loan sharks in Chicago break the legs of defaulting borrowers, but do not kill them?

Rationality implies decision making, and people often have to make decisions under conditions of profound uncertainty; fortunately, economists have devoted a good deal of attention to decision under uncertainty. A simple but important example of a law-related decision under uncertainty is the decision as to how much care to take to avoid an accident. The accident will occur with probability  $P$ , and let us assume that if it does occur it will impose a cost that I’ll call  $L$ , for loss; and assume further that eliminating the possibility of such an accident would impose on the potential injurer a cost, which I’ll call  $B$  (for burden). Then it is easily seen that the cost of avoiding the accident will be

less than the expected accident cost (or benefit of avoiding the accident) if  $B$  is smaller than  $L$  discounted (multiplied) by  $P$ , or  $B < PL$ , and if this condition is satisfied then the potential injurer can be said to be negligent if he fails to take the precaution. This is the negligence formula of Judge Learned Hand, announced in a judicial opinion in 1947<sup>6</sup> but not recognized as an economic formula for negligence until many years later. It is a simple formula but its elaboration and application to specific doctrines in the law of torts have generated an immense and illuminating literature.

By glancing at the Hand Formula you can see how an injurer could be deemed negligent even if the probability of an accident were very low (because  $B$  might be low or  $L$  very high), or even if the cost of avoiding the injury were very high (because  $P$  and/or  $L$  might be very high). You can put a minus sign before  $B$ , and thus model the case in which the injurer would incur a cost saving by not injuring: the case, in short, of deliberate injury; and you would see how in that case the injury is never cost-justified. Or you can think of  $B$  not as the cost of taking a precaution, but as the cost of reducing the output or other activity of the potential injurer, since that's another way of avoiding injuring people. And that will give you a clue to the role, or a role, of strict liability in the law. Suppose you kept a tiger in your backyard for self-defense, and the tiger got out and bit a neighbor's head off. It would be a case of high  $P$  and high  $L$ , and maybe high  $B$  in the sense that you couldn't have been more careful than you were to keep the tiger in your yard; but  $B$  might have been low if viewed as the cost of not having a tiger at all, but substituting another method of self-protection; and in fact this is a case where strict liability is imposed.

Well, I could go on and on with these examples, moving from one tort doctrine to another through the whole field of torts and then to contracts and property and so on throughout the legal system. But time does not permit that and if you want a fuller sketch of the field today, I suggest you take a look at my book *Economic Analysis of Law*, a new edition of which has just appeared.<sup>7</sup> I want to move on to the two specific uses of economic analysis that I said I'd concentrate on—making law simpler and challenging you to defend your values. I shall begin with a case that the Supreme Court decided in 1911, an antitrust case called *Dr. Miles*.<sup>8</sup> The issue was the legality under the Sherman Act of a contract that a supplier of patent medicines entered into with his dealers forbidding them to charge a price for his medicines lower than the retail price that he fixed; this is the practice known as resale price maintenance. The Supreme Court, holding the practice illegal, noted that it had the same effect as would an agreement among the dealers to fix the price at which they would sell *Dr. Miles's* medicines: a dealers' cartel. But the Court overlooked another effect. If dealers cannot compete in price, yet would

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<sup>6</sup> *United States v. Carroll Towing Co.*, 159 F.2d 169 (2d Cir. 1947).

<sup>7</sup> Richard A. Posner, *Economic Analysis of Law* (5th ed. 1998).

<sup>8</sup> *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

make money if they could sell more, they will compete in nonprice dimensions of competition, such as stocking more inventory or having better-informed salespeople. If these services are important to the manufacturer's marketing strategy, he can use resale price maintenance to evoke them. For by setting the minimum resale price above the dealer's barebones cost of sale, dealers will vie to get additional sales by offering customers more service, until eventually they bid away the profit built into the minimum resale price, which is just what the manufacturer wants.

A dealers' cartel would have this effect too; members of the cartel, each of whom would like to increase his sales at the cartel price because it's above cost, will try to attract customers away from other dealers by offering better service. The difference is that the dealer may be providing more service than the customer wants, in the sense that the customer might prefer a lower price with less service. If that is what the customer prefers,<sup>9</sup> the supplier, if he is doing the price-fixing, will give it to him; for otherwise the supplier will lose business and profits to a competitor. But if the customers want a lower price and less service, competition will force the supplier to give them that, provided the dealers aren't allowed to collude.

I now skip to what may seem an unrelated topic. Critics of the deregulation of the airline industry have pointed out that airline service is in some respects inferior to what it was in the days when it was a regulated industry. Planes are more crowded, there is less legroom, and the food is poorer. Gone are the piano bars from American Airlines' 747s. This is what economics predicted. The regulated airline industry was a government enforced cartel. Prices were kept high and as a result the industry was deflected into nonprice competition. When the airlines had finally competed away all their cartel profits in the form of service competition, the industry was ripe for deregulation. And when it was finally deregulated, price fell and with it the level of service, because this was what the consuming public wanted, as we can infer from the enormous growth in air travel since deregulation.

So we see, and this is the point of the discussion, that resale price maintenance of patent medicines and the deregulation of airline transportation raise the same economic issue, that of the relation between price and nonprice competition, even though one involves goods and the other services, one is old and one is recent, and one involves the judicial interpretation of the antitrust laws and the other legislative reform of common carrier regulation. And this is the sort of thing we encounter all the time in the economic analysis of law. Practices, institutions, bodies of law that seem wholly disparate from the standpoint of orthodox legal analysis are seen to involve the identical economic issue. Whole fields of law are interchangeable when viewed through the lens of economics. When I was a law student, the law seemed an assemblage of completely unrelated rules,

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<sup>9</sup> More precisely, the marginal customer, but I will not pursue that refinement. See Posner, note 3 above, at 321.

procedures, and institutions. Economics reveals a “deep structure” of law that exhibits considerable coherence.

Consider the famous tort case of *Eckert v. Long Island R.R.*<sup>10</sup> A man saw a child on the railroad tracks. A train that was being operated negligently (that’s crucial, as you’ll see in a moment) was bearing down. The man dashed forward, scooped up the child, tossed the child to safety, but was himself killed. Should the railroad be held liable to the rescuer for its negligence? Or should he be held to have assumed the risk? The issue is one of tort law but a helpful way to approach it is in terms of contract. Ask the question this way: if transaction costs, that is, the costs of negotiating a contract between the railroad and potential rescuers, had been low, rather than prohibitive because the potential rescuers were not identified, would the railroad have negotiated a contract whereby a rescuer of a person endangered by the railroad’s negligence would be compensated if the rescuer was killed or injured in the rescue attempt, provided he was acting reasonably? The answer is probably yes, the railroad would make such a contract. Here’s why. The railroad would be liable under tort law to the person saved if he weren’t saved. And so the rescuer would be conferring an expected benefit on the railroad for which the railroad would be happy to pay provided the expected cost of the rescue to the railroad was less. In *Eckert* the rescue was successful. Suppose the child’s life was worth as much as the rescuer’s, say \$X; and suppose further that the rescuer had only a 10 percent chance of being killed in the course of the rescue (and a zero chance if the rescue was unsuccessful). Then, ex ante, which is to say before the outcome of the rescue attempt was known, the railroad would have been eager to make the contract I have described. For the expected benefit to it would have been \$.9X, since in nine cases out of ten it would save the full \$X damages judgment.

While you ponder that example, let me move on to the second use of economics in law, what I have called challenging your values. I’ll use as my opening text a short article by the well-known Harvard political theorist Michael Sandel in a recent issue of the *New Republic*.<sup>11</sup> The article surprisingly conjoins approval of baby selling with condemnation of contracts of surrogate motherhood. A doctor named Hicks, practicing medicine in the rural South during the 1950s and 1960s, “had a secret business selling babies on the side.” He was also an abortionist, and “sometimes he persuaded young women seeking abortions to carry their babies to term, thus creating the supply that met the demand of his childless customers.” Sandel believes that the doctor’s “black market in babies” had morally redeeming features, thus unconsciously echoing a position that an economist and I took in an article published twenty years ago,<sup>12</sup> but he thinks that surrogate motherhood has no morally redeeming features.

<sup>10</sup> 43 N.Y. 502 (1871).

<sup>11</sup> Michael Sandel, “The Baby Bazaar,” *New Republic*, Oct. 20, 1997, p. 25.

<sup>12</sup> Elisabeth M. Landes and Richard A. Posner, “The Economics of the Baby Shortage,” 7 *Journal of Legal Studies* 323 (1978).

Sandel's attempt to distinguish the practices reveals an ignorance of basic economic principles. To begin with, he points out that compared to Dr. Hicks's "homespun enterprise, commercial surrogacy, a \$40 million industry, is big business." But Sandel is comparing one seller in a market to an entire market, and moreover one seller in an illegal market, where sellers conceal themselves, to an entire legal market. With more than a million abortions a year, the potential for "baby selling," if legalized, to eclipse commercial surrogacy is manifest.

Sandel's principal ground of distinction between baby selling and surrogate motherhood is different; it is that commercial surrogacy, unlike what Dr. Hicks did, encourages what Sandel, using a Marxist term, calls commodification, but which just means commercialization. "Dr. Hicks's black market in babies responded to a problem that arose independent of market considerations. He did not encourage the unwed mothers whose babies he sold to become pregnant in the first place." He did not have to. Demand evokes supply. Women who knew there was a market for their baby if they did not want to keep it would tend to use less care to avoid becoming pregnant. No doubt fewer women knew there was a market than would if it were a legal market rather than a black market. But Sandel does not suggest that Dr. Hicks's practice is redeemed by having been illegal!

I do not suggest that on the basis of my economic analysis those of you who are opposed to surrogate motherhood should give up your opposition. I don't believe that economics (or any other body of thought, for that matter) can compel a moral judgment. But those of you who are opposed to surrogate motherhood may feel pressed by my analysis to reconsider your opposition. Maybe you agree with Sandel that what Dr. Hicks did was not immoral even though it was illegal, and maybe you agree with me that Sandel has committed an economic error in thinking that what Hicks did was different from what the commercial surrogacy industry is doing and that it makes a difference that he was just one person and the commercial surrogacy industry consists of a number of persons.

Here is a different and (though I promised you simplicity) somewhat more complex example.<sup>13</sup> The federal pension law, ERISA, provides that if an employer establishes a defined-benefits pension plan—he doesn't have to establish any pension plan, let alone a defined-benefits plan, but if he does—it has to provide for the vesting of the employee's rights under the plan after five years. The purpose is to correct an abuse consisting of establishing a nonvesting pension plan and then firing an employee on the eve of his retirement.

The economist asked to evaluate this provision in ERISA would want to consider first how common this nonvesting scam would be in the absence of the law and whether forbidding it might have bad effects, in particular on the intended beneficiaries, the

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<sup>13</sup> The discussion that follows is based on Posner, note 6 above, at 371–374.



employees. Before the law was passed (in 1974), depending on the rules of vesting and of crediting years of service adopted by the particular plan a worker who left before retirement age might find himself with a pension benefit worth much less than his contributions and perhaps worth nothing at all. So he had a strong incentive to remain with the same company until he reached retirement age. And the employer had the power to expropriate employees' firm-specific human capital—which is to say the earning power an employee has that is tied to his working for this particular firm, so that he would earn less working for any other firm—by threatening to fire them before their pension rights vested if they insisted on a salary commensurate with their value to the company. One could imagine an employer reducing the employee's wage to a point at which the wage and the pension benefit together would just exceed the employee's wage in his next best job. So the year before the employee retired and became eligible for the pension the wage might be zero or even negative; the employee would pay to be allowed to work long enough to become entitled to his pension.

I may seem to have just made a strong economic case for ERISA's vesting provision. Yet empirical study has shown that pension practices were rarely exploitative before ERISA, and that the law was mainly motivated by abuses associated with multiemployer pension plans administered by the teamsters and other unions. The reason the companies' pension practices were not exploitative was first of all that the terms of retirement, including pension rights, are a matter of contractual negotiation between employer and prospective employee, not a unilateral imposition. Even if a particular employer refused to negotiate separately with each employee but offered terms of employment on a take-it-or-leave-it basis, competition among employers would give prospective employees a choice between different wage-benefit packages. The packages offered by some employers would emphasize good retirement or other benefits at the cost of lower wages, while those offered by other employers would emphasize high wages at the cost of less generous or secure retirement or other benefits. Employees would tend to be sorted to employers according to the individual employee's preferences regarding risk and the allocation of consumption over the life cycle.

As for incomplete vesting, by making pension benefits contingent on the employee's remaining with the firm and performing satisfactorily it facilitated the recovery by employers of their investment in their employees' firm-specific human capital. This would be expected to lead to more investment and higher wages. Incomplete vesting also solved the problem of the employee who being about to retire no longer has an incentive to work hard. It solved this problem, what economists call the "last-period problem," not only with the stick (the threat of discharge before pension rights vested) but also with the carrot, since pension benefits are usually heavily weighted in favor of the employee's wage in his last years of employment.

The employer's incentive to abuse the power that incomplete vesting conferred on him by reneging on his unwritten contract to deal fairly with his employees was held in

check by his concern with preserving a reputation for fair dealing (if he lost that, he would have to pay new employees higher wages) and by the bargaining power that the possession of firm-specific human capital confers on a worker. (If he quit in anger or disgust, or was fired to eliminate his pension benefits, the firm would have to invest in training a green employee to replace him.) In fact, as I have said, before ERISA opportunistic discharges of workers covered by a pension plan were rare; and the statute has had no detectable impact on discharges of covered workers.

But by limiting incomplete vesting, the Act has tended to reduce the control of employers over their older employees. Such a loss of control would be expected to have two bad effects on the employees themselves. The first would be to lead employers to invest less in the employees' firm-specific human capital, and so the employee's productivity and hence wage will be lower. Second, because employers would have a smaller investment in the employees to protect and the employees would have less incentive to perform well (not being faced with a substantial loss of pension benefits if they were fired), employers would be expected to resort more frequently to an explicit or implicit threat of discharge in order to maintain discipline. And third, anything, legal or otherwise, that adds to the cost of employing a worker will cause employers to employ fewer workers or to pay them lower wages or both.

Even if you agree with my economic analysis, you may feel that on balance it is more important for workers to have secure pension rights or greater autonomy from their employers. But, once again, you will be forced to ask yourself whether your feeling is strong enough to offset the consequences brought out by economic analysis, including adverse consequences on the workers themselves, in the form of lower wages—or even, ironically, *less* secure employment.

I've given two examples of what might be called the "conservative" bias of economics. But actually economics is pretty value-neutral, or at least aspires to be value neutral, and there are many liberal practitioners of economic analysis of law, such as Guido Calabresi of Yale and now of the Second Circuit and John Donohue of Stanford. And so I'll close with an example of how economics can throw some cold water on a policy that conservatives favor.<sup>14</sup> Consider statutes that empower the government to designate a building's façade as a landmark; upon designation, the owner cannot alter the façade. An alternative to designation would be the purchase (possibly backed up by the threat of condemnation, subject to payment of just compensation) by the government of an easement in the façade. This is favored by most conservatives. They believe that the government should not be permitted to get things for nothing and in the process impose heavy costs on the owners of property. And so they urge that the principle of just compensation be given maximum play. They would be inclined to argue, these conservatives, that landmark-preservation statutes lead the government to designate too

<sup>14</sup> The discussion that follows is based on *id.* at 66–67; Daniel A. Farber, "Economic Analysis and Just Compensation," 12 *International Review of Law and Economics* 125, 131–132 (1992).

many landmarks compared to a regime in which the government must pay the owner of the landmark for the reduction in his property values as a result of his not being allowed to alter the façade.

Actually, it is unclear that there would be fewer landmarks designated under the payment approach. The very fact that there is no compensation under the typical landmark-preservation statute means that landmark owners will resist designation by complaining to their congressmen, bringing other pressure to bear on the designating authority, hiring lawyers to find loopholes in the statute, even organizing the defeat or repeal of the legislation. The resistance of taxpayers to paying the taxes necessary to finance a program of buying landmark easements might be less. Government tax and spend programs (agricultural subsidies, for example) are often as socially costly as regulatory programs, the costs being spread so thinly over the taxpaying public that few taxpayers squawk.

Might the government, however, because it isn't putting its money where its mouth is, designate the "wrong" landmarks, that is, property that would be worth a lot more in an altered state? Possibly not, since the greater the alternative value the stronger the resistance to the designation. There is, to be sure, a danger of reducing the supply of landmarks under the designation approach; building owners may rush to demolish potential landmark façades in advance of designation. But that is not the nature of the conservatives' objection.

The basic problem with that objection is its implicit assumption that the government is an ordinary purchaser and so responds to financial incentives just as a private purchaser would. The government is not an ordinary purchaser, and in fact it is meaningless to speak of *making* the government pay for the things it wants just like everybody else, when the government *must* resort to coercion to obtain the money it uses to pay for the things it wants. To pay just compensation for a taking, or even to make a voluntary arms' length purchase without any implicit threat of resorting to condemnation if the seller refuses to sell, the government must first take, without any compensation, the necessary funds from the taxpayer. Just compensation entails an anterior act of expropriation.

So, once again, given the practical consequences illuminated by economics of substituting a payment scheme for the present landmark designation statutes, those of you who support the just compensation principle on moral or political grounds will have to consider how much you're willing to pay for the principle, for it may turn out that government may take more resources out of the private sector and freeze more landmarks if it is forced to the just compensation route rather than the landmark designation route.

As these examples illustrate, the role of economics in moral and political debate is to draw attention to consequences or implications that people ignorant of economics commonly overlooked. What you do with those consequences is your business. The basic job of the economist is to remind us of the consequences, often though not always

adverse or at least costly, of acts or practices that we might otherwise think clearly good or clearly bad.

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