Between Utopia and Alignment : Guidelines for the Economic Analysis of Law

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Between Utopia and Alignment : Guidelines for the Economic Analysis of Law

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1 Introduction

In recent years, the economic analysis of law has developed from a small sideline known to only very few specialists into a large subdiscipline of economics. Due to its applied character, economic analysts of law can exert an immediate influence on current decision-making, and it is therefore not surprising that leading practitioners in the field regularly surface in the news. Perhaps the most recent example was the role the mediator Judge Richard Posner, one of the leading practitioners of law and economics, had played in the Microsoft case. The recent appearance of several textbooks, handbooks, encyclopaedias and anthologies is a further sign of the consolidation of the field of law and economics (Backhaus, 1999 a).

The European process of market integration with its dual dimension of integrating further and more markets and integrating them also more deeply in terms of removing barriers and harmonizing the legal framework in which market exchange takes place has somewhat surprisingly given law and economics an additional function. This function consists in two aspects. On the one hand, different legal traditions need to be merged in terms of common principles. Here, economic analysis can provide the framework of principles and thereby assumes a normative quality. A fine example is the principle of subsidiarity (Backhaus, 1999 b). On the other hand, European institutions such as the Commission actively intervene in economic areas, such as specific markets on the basis of economic theory. The recent initiatives of the Commissioner for competition form a good example (see Backhaus & Hansen, 2000), since the choice of theory also informs the political action that needs to be taken. In such a case, the result of the analysis determines the competences of different political actors.

Economic analyses are needed for a variety of different applications. Their format will therefore differ according to the application for

which they are needed. In this "how-to" guide, first a survey over the most important applications is offered and a discussion follows of the steps necessary for an economic analysis of a legal problem at a professionally acceptable level.

2 Three Types of Analysis

In principle there are three different kinds of analysis :

1. an evaluative analysis
2. a positive analysis of legal structures (economic reconstruction of legal argument)
3. a normative (welfare) economic analysis.

These three types differ in the economic method and approach to the problem. An evaluative analysis tries to analyse, on the basis of an economic model, the consequences of a particular legal decision or set of decisions or else an act. A positive analysis aiming at reconstructing the structure of a legal argument or doctrine aims at illuminating complex legal reasoning that cannot be reduced to one or a few organizing principles of legal doctrine. Hence a legal theory is substituted by an economic theory. While these first two types of analysis differ in their level of abstraction, they both belong to the realm of positive (and therefore not normative) analysis. This implies that the analytical conclusions are in principle testable and therefore need to be presented in a testable form. Although it will not always be possible to run empirical tests for all the relevant conclusions of an economic analysis, an appropriate test procedure and the relevant data sources should be indicated side by side with a statement indicating which test results would refute the analytical conclusion.

A normative (welfare) economic analysis is different. Its purpose is to distil normative conclusions from a limited set of value judgments. Since legal reasoning is based on value judgments, the task of the economist is to explore the relationship between the various value judgments underlying legal discourse and to indicate where and how they may conflict. If i.e. a particular value judgment is to be given precedence over others, the normative economic analysis can show to what extent this priority will compromise attainment of other traditional goals. In this case, the economist tries to give expression to lawyers' values to their fullest possible extent.

Since this exercise is actually a sophisticated tool of good lawyering and thus by necessity decision oriented and normative, it does not lead to testable applications. Whether the analysis is correct or not, can still be ascertained by testing its logic.

3 Different Applications

The first distinction concerns the economic method or approach. A second distinction refers to the different uses of legal economic analysis. Economic analyses of legal problems are used in vastly different contexts. In court cases, economic experts have traditionally played a role when specifically economic expertise (such as the likely effects of mergers) was required. With the expansion of law and economics as a sub-discipline to virtually every aspect of legal applications, the economist's role has likewise become a broader one. The scope of a legal economic analysis of a court expert will depend on whether the expertise is required for elucidating the particulars of a single case or whether an assessment of the likely consequences of setting precedent is called for. In the first case, the application of received economic knowledge and exercise of standard techniques is normally sufficient, whereas in the second case a model may have to be developed (and tested).

A legal economic analysis plays an important part in administrative applications as well. Again, there is a substantial distinction between the analysis of the application of a specific rule to a particular case or whether the impact of the rule on all the cases to which it is applied has to be analysed. Again, in the second case an explicit model will have to be constructed.

The most genuine applications of an economic analysis to legal problems occur at the legislative level. Since at this level we will normally observe a competition between different proposals the task of the economist is to sort out which respects of the differences between them are economically relevant. Hopefully, a single model of relevance can be developed that encompasses the competing proposals. The broader the impact of the legislation under consideration, the more thorough hypothesis testing will be required.

4 General Guidelines

Apart from the differences between these various types of analytical approaches to be discussed shortly, there are six recommendations which should be heeded in any event.

1. The purposes of a particular decision or rule need be strictly differentiated from the outcomes of that decision or rule. A frequent misunderstanding grows out of the assumption that the two coincide, and it is often the task of the economist to show how and why they do not.
2. The economic analysis must be kept pure in the sense that no additional assumptions not contained in the model must enter. In parti-

cular, the theoretical model must be kept separate from the empirical base.

3. The economic analysis of a particular legal rule or decision must not be kept to the confines of that rule; very often, there are consequences going beyond the area to which the rule or decision was meant to apply. These wider consequences may actually be more important than the narrower and intended ones. It is the task of the economic analyst to render as complete a picture as possible.
4. At every step the analysis should be kept empirically open in the sense that empirical knowledge that is or might be available can be systematically introduced.
5. Legal rules and decisions have to be analysed in terms of whose decision-making they are able to affect. Economics is a science about decisions taken by agents, and the consequences of legal decision-making are the composites of those decisions with respect to rule making. The legal economic analysis can only be institutionally relevant if the deciding actors have been correctly identified.
6. Finally, the economic analyst, in presenting his results, needs to keep in mind how much and which information his lawyer counterparts are able to digest and work with. A careful process of translating and simplifying without falsifying may be necessary.

5 Preliminary Steps

- Step 1 Define the problem to be analysed and state what types of answers can be expected.
- Step 2 Disassemble the problem and reduce it to a sequence of legal questions with as small a residue as possible (see step 4).
- Step 3 Make every legal problem correspond to an appropriate set of legal norms and indicate the norms.
- Step 4 (the residue) Now structure the residue.
- a) List all the questions of fact and indicate the most appropriate method for establishing these facts.
 - b) List all the questions of theory, state the questions precisely in terms of and side by side with the appropriate theory or theories to be invoked.

6 Analytical Steps

- Step 1 State the basic problem in economic terms, develop one unifying model of reference and indicate the iterative steps needed to develop the model in several variations until it fits the problem at hand. State the possible outcomes of your model-based analysis.
- Step 2 Select and list the norms and legal terms the interpretation of which will be critical to the outcome of the analysis and give an economic analysis one by one. You must precisely state the theory which you use for this analysis and ensure that the premises remain the same as in the general model of reference.
- Step 3 List the solutions (of step 2) and translate them into the language of the legal norms. Draw the conclusions.
- Step 4 Now carry through the analysis as a whole by using the model developed in step 1 and the interpretative results from step 3. State the outcome.

7 Model Variations and Sensivity Analysis

The four steps of part 6 may have to be repeated for the main alternatives under consideration.

- Step 1 Try to incorporate the main variations of the conclusions (6.4) into the same model and discuss the outcomes.
- Step 2 Highlight the critical assumptions on which the solution depends.
- Step 3 Ascertain whether the model is robust with respect to those assumptions and, if it is not, indicate precisely where the model applies.
- Step 4 Give a survey of the most important competing models not used in this analysis and indicate the reasons for your preference. If that preference is only slight, you may have to repeat the analysis in terms of the second best model.
- Step 5 Translate the results of your analysis and the main steps by which it came about into legal terms.

8 Specific Observations

A couple of observations apply specifically to the different approaches and uses.

<u>Evaluative</u>	<u>Positive</u>	<u>Normative</u>	<u>Analysis</u>	<u>Applications</u>
1	2	3		Courts
4	5	6		Administr.
7	8	9		Legislative

1. Most of the analyses needed in court situations are straightforward applications of economic techniques. Here, reliance on empirical data is particularly called for. Since the expert is brought in to help determine the case one way or the others, he should expect to be confronted with a counter expert. Critical assumptions of the economic analysis are eagerly picked up by lawyers, particularly in adversary procedures. This tends to confuse all parties involved, including the judges. Therefore, one has to be careful to avoid jargon and to state assumptions and conclusions in clear terms. The model itself should be kept basic.
2. When trying to reconstruct involved court decisions in terms of positive economic theory- this is the art Judge Posner has developed to mastery- it is important to trace the roots of the conflicting aspects of court decisions. The conflicting outcomes may result from any one of the following causes :
 - a) Faulty reasoning (unlikely in high court decisions) (but see Tullock, 1994)
 - b) Implicit factual assumptions that have to be brought to the surface and proven correct or incorrect.
 - c) Incorrect use of non-legal terms
 - d) The incorrect generalizations from non-legal theories
 - e) Uncertainty of the courts about the likely outcomes of their decisions.
 - f) Conflicting intentions of traditional decision-making.

For the economic analyst it is important to pinpoint one or several of these problems and focus on their resolution. The results of the economic analysis will be become to the court decision makers as long as they clearly improve upon their lawyering. The judicial intentions have to be clearly formulated and need to enter the analysis. Much of the opposition to the economic analysis of legal problems such as Posner's stems not so much from an aversion to economic analytical techniques as from a sense that the economic analysis is a Trojan horse carrying ideological value judgments not shared by the court.

3. Welfare economic analyses often revolve around highly technical questions that can have important consequences. An example is the proper choice of a discount rate in compensation cases. The economic analyst should be aware of these arguments and state them explicitly in his brief while not relying excessively on dubious assumptions (see part 7 above).
4. In administrative decisions typically more time is allowed to prepare an argument. Therefore the level of sophistication can be substantially higher. This will in particular refer to the empirical corroboration of the analysis. The administrative agency may actually be helpful and assist in data gathering and processing.
5. When attempting to reconstruct in economic terms a whole set of legal norms such as an administrative decree or an act, the analyst should determine what shaped the act and its current interpretation and implementation. It is unrealistic to assume that an economic analysis can bring about a change in either the act itself or its interpretation or its implementation if that change runs counter to the intentions of powerful pressure groups. It is not the task of the economist to change the political balance. The economist has to take the political status quo as given and try to improve upon it in the Pareto sense. Hence, a political economic analysis of the legal norms under consideration is likely to be necessary. This does not mean that the economic analyst should skirt the difficult "political" or distributive issues. It is quite appropriate and sometimes welcome to elucidate distributive consequences of alternative decisions side by side with the emphasis on allocation. Only where one alternative is clearly superior to the other in the Pareto sense should the economic analyst make this judgment, and explicitly so.
6. In some administrative procedures, explicit normative economic analyses are called for. When i.e. environmental impact statements are required, the analytical techniques used should be clearly described. Confusion about those techniques can lead to a perversion of their results.
7. There is no doubt that the economic analyst can play a role of the greatest importance in the legislative arena. Economics is most useful when applied to a large number of similar cases, and this is the case when a piece of legislation is to be enacted. Since most legislation is controversial, the economic analyst should try to stay outside the political turbulences while being aware of the different pressures involved. Nothing hurts the standing of an economic analyst more than being involved in a heated discussion with another economic analyst in public. Questions of economic methodology cannot always be resolved. They can never be resolved in the political arena. In order to be successful, it is important to stress the areas of agreement among economists and state but not controversially discuss the points of disagreement. In an evaluative analysis of this kind,

heavy reliance on empirical techniques with large databases is particularly useful. The economic analyst who is also politically involved should state clearly where the analysis ends and the political persuasions begin.

8. When analysing legislative proposals or laws that have to be passed or may have to be amended, the economic analyst should keep in mind that the impact of a law begins much earlier than the date at which it gets passed. The more important the legislation is, the more forceful will be the reactions to it before its enactment. The economic analyst should therefore try to construct a model which takes into account the likely reactions of those affected by the law; and spell out the consequences of alternative proposals in these terms. Far-reaching legislative proposals often have consequences even if they are not enacted. In order to avoid such unintended consequences, it is wise and makes economic sense to provide for loopholes and clauses allowing to opt out of the provisions of the law. Often the distributive consequences of particular pieces of legislation foster so much opposition that a well thought out and balanced piece of legislation cannot be passed. In that case a long transition period and an effective date pushed far into the future can prove to be an attractive solution (see Frey, 1983, p. 29).
9. In the legislative process, the economic analyst can play an important and helpful role by spelling out the implications of different political persuasions. In this way, deadlocked committees can sometimes be gotten moving again. In order to make welfare economic analyses useful for these applications, it is important to translate them into plain day-to-day language.
10. A short guide to the literature. A legal economic analysis which follows roughly the approach outlined above can be found in Backhaus 1987, a book which gives a legal-economic analysis of one court case. The classical works in law and economics are, of course, Calabresi 1970 which he followed up with Calabresi and Bobbitt 1978 as well as Posner's *Economic Analysis of Law*, (third edition 1986). An alternative institutionalist approach can be found in Samuels and Schmid 1981. Texts commonly used at American universities include Polinsky 1983 and Shavell 1987. The text by Ogus and Veljanovski (1984) offers a collection of relevant readings, and widely used although somewhat opaque is Veljanovski 1982. Most texts de-emphasize procedural law, but Tullock 1980 is a notable exception. His book is particularly accessible to the non-economist. An excellent case study is Reuter 1983 which has meanwhile appeared in a student edition. While most of the literature is in English, the German literature is also extensive, most of which is quoted in Adams 1985 and Backhaus 1987. The most important journals in the field are The Journal of Law and Economics, The Journal of Legal Studies, The Journal of Law, Economics and

Organization, The International Review of Law and Economics, and last, but not least, The European Journal of Law and Economics.

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Résumé

Le processus d'intégration européenne doit faire face aux incompatibilités possibles entre des règles issues de sources différentes. L'analyse économique permet de dépasser ces frictions. Cet article propose un certain nombre de règles montrant comment l'économiste peut remplir son rôle sans se substituer aux autorités législatives et juridiques.

Abstract

The process of European integration leads to further and deeper differentiation of legal rules stemming from different sources. Frictions and incompatibilities between these legal rules need to be overcome, and economic analyses can serve towards this purpose. This paper tries to develop guidelines on how the economic analyst can fulfil his role without replacing those endowed with legislative or jurisdictional authority.

Mots clé

méthodologie, analyse économique du droit

Key words

methodology, law and economics

Classification JEL : K10.