

THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW

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This is an encyclopedia with a romantic sensibility. It rejects the eighteenth century faith that inspires most encyclopedias, the faith in enlightenment through the systematic collection and ordered presentation of knowledge. And it rejects the bundle of assumptions associated with this world view: that a subject can be unified by method or topic, circumscribed by well-defined epistemological boundaries, and divided into mutually exclusive and logically coherent categories that can be conveniently assigned to different specialists. If a traditional encyclopedia makes one think of the imperturbable and unromantic geometric perfection of a French garden, this one is dense and luxuriant like an English garden, with all the delights and frustrations that entails.

The New Palgrave Dictionary of Economics and the Law is a vast and unwieldy work consisting of three heavy volumes, hundreds of entries, and thousands of pages. It is not really an encyclopedia of law and economics, though that is the field it is closest to being an encyclopedia of. It includes essays about the law with no reference to economics (rule of law), essays about economics with no reference to the law (cheap talk and coordination), essays on justice (social justice), essays on political philosophy (modern utilitarianism), essays on recent political events (transition in Eastern Europe), and biographies of people rarely discussed in law and economics (Lon Fuller, Carl Menger, Alexis de Tocqueville) as well as biographies of acknowledged contributors (Calabresi and Coase). The essays themselves overlap in complex ways, my favorite example being the three essays on corporate bankruptcy (Chapter 11, corporate bankruptcy, corporate reorganisations), two essays on personal bankruptcy (personal bankruptcy, personal bankruptcy in the United States), and one essay on both (bankruptcy and its reform), but look also at the essays on property rights (evolution of property rights, investment incentives and property rights, possession, first possession, property rights, property rights in civil law, residual rights of control), on social norms and conventions (conventions, conventions and transaction costs, efficient norms, law and social norms), and on the Eastern European transition (corruption in transition economies, economic legality and transition in Russia and Eastern Europe, legal reform in Eastern Europe, privatisation in Central and Eastern Europe, transfer of property rights in Eastern Europe, transition in

¹ Professor of Law, University of Chicago. Thanks to Saul Levmore for helpful comments. I should disclose that I contributed an essay on 'efficient norms' to the volumes under review. Also, the book review editor has asked me to give the perspective of an American (as opposed to European) lawyer (as opposed to economist).

Eastern Europe). This is not to say that essays on the same topic are always redundant. The authors do not always or even usually present surveys of the topic assigned to them, but instead repeat arguments they have made in the past, or propose a new idea, or simply focus on different aspects of the topic. So two essays on such similar topics as precedent and *stare decisis* provide lists of references that have only one citation in common. The effect is kaleidoscopic. We are presented not with the state of the literature, but with shifting, overlapping, and conflicting perspectives on a set of ideas having to do with law, economics, and 'law and economics.'

But there is said to be order. In a brief preface Peter Newman, the editor of these volumes, distinguishes *law and economics*, which refers to a particular body of scholarship, and *economics and the law*, which refers to the interchange between 'ethics, moral philosophy, political philosophy, economics, and law' (p. ix, quoting James Coleman), which sounds like just about anything having to do with society, politics, and economics – a suspicion that is confirmed by the vast number of entries on social norms and conventions, the organisation of government, and the structure of markets. Law and economics is a discipline; economics and the law is an aspiration.

Law and economics. Modern law and economics is a body of scholarship that has been produced mainly by American law professors over the last thirty years. Some of these law professors have formal economic training, but most do not. Almost all of these professors have formal legal training, though the handful of exceptions includes such notable contributors as William Landes, Steven Shavell, A. Mitchell Polinsky, and, of course, Ronald Coase. In recent years, an increasing number of non-Americans and non-lawyers have made contributions to law and economics, but their influence on the American body of scholarship has been, so far, relatively small.

Law and economics is a subdiscipline of legal scholarship, not of economics. Most practitioners of law and economics write for an audience that they imagine to consist of legal scholars. Few expect their audience to include economists generally. Most publish in student-edited law reviews, which are the main scholarly outlet for law professors but which are rarely read by economists, and specialized faculty-edited law and economics journals, like the *Journal of Legal Studies*, whose circulations are well below those of the most important economics journals. Influence, prestige, and professional reward go to practitioners of law and economics who persuade legal scholars that a particular law has an interesting, unintuitive economic explanation – and not to those who publish in the *American Economic Review* or the *Economic Journal*. A young professor in an economics department will not go far in the economics profession if he decides to devote his life to using economic tools for the purpose of understanding the law. By contrast, this is an established route to the scholarly version of fame and fortune in the legal academy.

American law faculties, like many scholarly faculties that are defined by subject matter, divide along methodological lines. Most faculties can roughly be divided into doctrinalists, historians, philosophers, law and economics scholars, and leftists, with a sprinkling of psychologists and sociologists.

Doctrinalists engage in traditional legal scholarship, which consists of explaining how judicial decisions flow from precedent, statutes modify earlier statutes and the common law, and so on. They are interested in describing what the law is. Outside of constitutional law, most doctrinalists are older, and their influence is waning. Those traditional doctrinalists who maintain their influence usually do so because they read heavily in the other disciplines, and allow them to influence their scholarship; this is especially true of constitutional and public law scholars, who retain significant influence.

Legal historians remain influential and important, though there are usually only a handful on each faculty. Leftist scholarship – especially feminist and race-related scholarship – is currently fashionable and influential. Philosophers contribute to the field of jurisprudence, and occasionally have useful things to say about other areas of legal scholarship. On a top law faculty, with some exceptions, there is a small but important group of law and economics scholars, and then a penumbra of scholars who are interested in economics but are mainly focused on other things.

I mention these things because to understand law and economics one must understand that its contributors are driven by the need to prove to their law colleagues over and over that economics sheds light on legal issues, and in particular on the legal issues that concern law professors. Law and economics scholars must compete with other legal scholars for funding, for appointments, for influence. This competition has shaped the field of law and economics.

Let me give you an example. In American contract law, if a person breaks a contract, the victim is generally entitled to expectation damages, which equals the difference between the contract price and the value that the victim attaches to performance. There are several other remedies, the most importance of which is specific performance, which is an injunction issued by the court ordering the promisor to perform the contract, on pain of a substantial fine or even jail time if the promisor disobeys. A host of other doctrines circumscribe these basic contract remedies.

These doctrines pose a variety of questions. How might the choice of remedy affect people's behaviour? Are people more likely to breach contracts under one doctrine than under the other? Is any doctrine more desirable than the others? Are any desirable compared to an unspecified alternative? These questions present themselves to law professors in a variety of settings. Their students want enlightenment; practicing lawyers want to know what principles they can invoke in order to persuade courts to depart from precedent and award the remedy that their clients desire the most; courts and legislatures want to know the consequences of the different remedies, and their consistency with public policy concerns. All of these demands require a carefully, scholarly approach to understanding the law.

It is remarkable that before the advent of law and economics in the 1960s and 1970s the literature on contract doctrine mostly ignored these questions. Most of the literature was doctrinal or historical. The scholar would read as many cases as he could, and try to understand what the doctrines were. When scholars speculated about the consequences of the different remedies, the

speculation was crude and unsystematic. When scholars speculated about the normative presuppositions of the different remedies, the speculation was usually based on quite general ideals (enhancing the market, or protecting the poor, or vindicating corrective justice) that could not in fact differentiate among the doctrines. Economics changed all this. The rational actor model enabled scholars to describe with precision the potential effects of the different doctrines. In the process, they considered issues that earlier scholars had overlooked. They discovered that one has to be careful about specifying the kind of behaviour that might be influenced by different contract remedies. Different remedies may have different effects on whether the promisor breaches or not, but also on how the parties renegotiate their contract in light of changed circumstances, whether they enter a contract in the first place, what kind of information they will reveal to each other during pre-contractual negotiations, and so on. Scholars also realised that one has to be careful about the assumptions one makes about the parties, such as whether they are risk-averse. And they discovered that one needs to specify one's normative criteria, like the Pareto standard, and take account of alternative institutional arrangements, like vertical integration.

The law and economics literature on contracts has investigated all these questions. I will use a quick example of an early contribution that attracted a lot of attention among conventional legal scholars, and helped ensure the rapid spread of economics. Expectation damages did not seem obviously superior to another remedy, reliance damages, which gives the victim his actual costs (not opportunity costs) and has been awarded only in unusual circumstances. Some scholars argued that reliance damages, because it focused on the harm incurred by the victim of the breach, was a morally superior remedy. Economists pointed out that one advantage of expectation damages, compared to reliance damages, is that they will deter a promisor from breaching except when it is efficient to do so. To see why, imagine a contract under which a seller must deliver goods to the buyer in return for \$100. The buyer has 'relied' on the contract in the sense of having invested \$5 in modifying his factory in anticipation of receiving the goods, and he values those goods at \$120. Prior to performance, a second buyer approaches the seller. Suppose first that the second buyer offers the seller \$150 and values the goods at \$150. Under both expectation damages and reliance damages, the seller will break the contract with the first buyer, pay him either \$15 (under expectation damages) or \$5 (reliance damages), and sell the goods to the second buyer for \$150. Now suppose that the second buyer offers the seller \$110 and values the goods at \$110. Expectation damages will deter the seller from breaking the contract ($\$15 \text{ damages} > \$10 \text{ gain from breach}$), whereas reliance damages will not deter the seller from breaking the contract ($\$5 \text{ damages} < \$10 \text{ gain from breach}$).

This leads to an interesting normative consequence. Expectation damages produces the Pareto-optimal result in both cases, whereas reliance damages does not. Under expectation damages, the buyer either receives the goods or is fully compensated, so in neither case is he made worse off. The seller either

obtains more than under the original contract or the same amount. By contrast, under reliance damages the seller will breach inefficiently, making himself better off but the buyer worse off.

This is only the beginning of a very complex analysis. One must worry about how these rules affect other incentives as well, such as the incentive to reveal information or to enter a contract in the first place. One must consider whether the parties can renegotiate when the new buyer appears. (See the entry on contracts for a lucid discussion.) But this very simple beginning made a great impression on contracts scholars, because it finally offered a tractable way to understand contract remedies, and by extension all of contract law, from a positive and normative perspective. It allowed legal scholars to understand the variety of legal mechanisms designed to protect consumers and poor people – the unconscionability doctrine, usury laws, bankruptcy laws, information disclosure laws – have costs as well, and indeed may injure some of the people they are designed to help by increasing the cost of credit and other goods and services. Outside contracts, economics allowed legal scholars to understand negligence as a cost-benefit analysis; the choice between strict liability and negligence as a choice between ways of minimising the aggregate costs of accidents; prison as a price on criminal conduct; and zoning laws as taxes on certain uses of property. Examples could be multiplied.

The common thread of law and economics is not the application of economics to the law, but the application of economics to legal problems that have always puzzled law professors. In this sense, legal scholarship has set the agenda for law and economics. This is not to say that an outstanding practitioner of law and economics cannot add new items to the agenda of the law professor. The point is that, generally speaking, certain kinds of contributions by economists and economically oriented lawyers will not 'count'. Chief among these are mathematical formalisations, no matter how ingenious, of insights that are already understood. Another is the contribution that may seem to an outsider to be about law and economics but is not about the main topics of legal scholarship – like, say, the effect of minimum wage laws on the labor market, or the effect of capital punishment on crime, or what kind of contracts are used by firms in a particular industry, or how best to design a contract in order to prevent an agent from shirking. At the same time, legal scholarship that violates standard economic assumptions also does not count as law and economics. These pressures and restrictions give 'law and economics' its coherence and its status as a sub-discipline separate from economics, on the one hand, and law, on the other.

Economics and the Law. Economics and the law, as understood by Peter Newman, is not a subdiscipline of law or of economics, but really a subject matter consisting of the intersection of economics, philosophy, sociology, etc., and the law – in other words, everything that one might think about law and law-related matters. In his introduction, Newman focuses on three areas of economics and the law that he believes are of particular importance: transaction costs, game theory, and norms and conventions. What is striking about

this list is that, while it is a perfectly plausible speculation, it happens not to be true about 'law and economics.'

What I mean by this is that 'law and economics' is dominated by the basic Coasean transaction cost framework, and so far game theory and discussion of norms and conventions have had little influence. The contract analysis described above reflects the Coasean approach. If transaction costs were zero, then courts should enforce whatever contracts parties agree to. Because they are not, courts must fill in the gaps in contracts left by the parties. The damages remedies are understood to be the default rules that courts draw on when parties do not supply a damages rule themselves as a term of the contract. It's not that one could not analyze this problem from a game theoretical perspective; one can. It's just that in the mainstream of law and economics no one – for the most part, and until recently – has. And indeed one sees the standard transaction costs approach in the vast majority of the Dictionary's entries on traditional legal rules: copyright, privacy, contracts, gratuitous promises, breach remedies, punitive damages, corporate law, and so on.

Game theory has swept most areas of applied economics – like industrial organisation and international trade – but has had little influence in law and economics. Part of this is no doubt due to the different institutional infrastructures of law and of economics in the United States. Innovations in economic theory are quickly disseminated through economics graduate students, whereas law students are rarely taught more than the rudiments of economics, and law professors must painfully teach themselves these innovations or find economists to collaborate with. Not only that: they must also find an audience. Mainstream economists are generally not interested in applications of economic theory to legal issues. And other law professors do not understand game theory. There is a coordination game that can be solved only after a long delay.

A further problem is that there is, I think, a general scepticism among law professors about whether game theory has much value for institutional problems of the sort that law professors care about. Or, to be more precise, lawyers might recognise that game theory is useful, but except when used for general heuristic purposes, its apparatus is just too cumbersome. Yet the Dictionary contains ten essays on game *theory* (as opposed to applications) that contain few references to legal issues, and another twenty-seven essays on game theory applications, yet only a few concern traditional legal topics (for example, comparative negligence), with the rest devoted to more esoteric or speculative ideas (bounded rationality, conventions at the foundation of law). Thus, the Dictionary itself fails to support Newman's view that game theory has been important for understanding the law.

Newman also believes that a thorough understanding of conventions and social norms is indispensable to 'economics and the law.' It is easy to understand why he thinks this. There are important parallels between laws and conventions; moreover, the existence of conventions poses important problems and opportunities for legal intervention. However, this is not the

traditional approach of 'law and economics.' That methodology has almost always assumed that the government is exogenous, and either solves market failures by producing and enforcing desirable laws, or makes mischief by producing and enforcing laws that benefit interest groups. Rarely do law and economics scholars investigate why anyone pays attention to the government, which is as deep and puzzling a question as why people pay attention to conventions and social norms. And rarely do law and economics scholars discuss how conventions and social norms may interfere with the law. The reason for this state of affairs is that these questions have generally not been on the agenda of legal scholarship. Traditional legal scholars have always thought of themselves as giving advice to courts or legislatures; hence these institutions are treated as exogenous. The main exception to this generalisation is Robert Ellickson's well-known book, *Order Without Law*, which has, after a delay, produced a surge of interest in the relationship between law and social norms. But this scholarship is a very recent phenomenon, and it is too soon to tell whether it will have major influence. So it is striking that the Dictionary contains almost twenty essays on conventions and norms – few of which, again, refer directly to standard legal problems discussed in the literature.

Having said all this, I must confess that I am very much on Newman's side. I believe both that game theory has been underused and that the relationship between law and social norms is a fertile area of research. So I am glad that he has edited the Dictionary the way he has. But he has taken a risk, and he must know this. If he is wrong, then scholars will wish that more of the Dictionary had been devoted to careful surveys of the existing literature, and less to social norms and conventions, game theory, political philosophy, and history. As it is, the Dictionary will be more useful for experts looking for stimulation and new ideas than for novices because, as I mentioned at the beginning of this review, most of the entries are fragmentary, speculative, and adventurous rather than systematic. There are too many entries on the same things, and many of them on things that are not part of the tradition of law and economics. The Dictionary drowns in detail; it could have been a single volume. There is also a significant, unfortunate gap: almost nothing on applying empirical methods to legal issues. But if Newman is right, then he has done law and economics a great service. He will have helped push it into new and exciting areas of scholarship. His Dictionary will have more influence than the standard backward-looking dictionaries, encyclopedias, and handbooks, which are content with surveying existing scholarship rather than thrusting it in new directions.

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