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Content

Normative Law and Economics: Asking the Right Questions

Alessio M. Pacces

I. Introduction[1]

Law and economics is a school of thought broadly concerned with the Economic Analysis of Law (EAL).[2] This has been a powerful intellectual movement, influencing the legal and the economic scholarship worldwide. The intuition is an extremely simple one, namely that law has economic effects. Understanding the economic effects of legal rules can lead to better laws. But also, law can improve economic outcomes.

The question motivating this essay is how law and economics can be 'normative,' that is, how this approach can inform policymakers about which legal rules are desirable. EAL has intrinsically some normative flavour. Granted that law can be coercive and affects economic outcomes, it is difficult to resist the temptation to try and improve those outcomes. In contrast, the positive approach to EAL focuses exclusively on the outcomes of legal rules without moving on to the question of which outcome – and hence which legal rule – is desirable.

The law and economics movement started with positive analysis. In his seminal article, Ronald Coase (1960) pioneered the study of legal rules from an economic perspective. The so-called Coase Theorem that subsequent scholarship derived from that article has, in fact, no normative component. The theorem states that, when the property rights are clearly specified, the market mechanism will reach economic efficiency unless the costs of using that mechanism – labelled transaction costs – are too high. As Coase (1992) subsequently made clear, he never wanted to imply that markets are infallible (a normative statement), but simply that in order to understand the functioning of markets, we should study transaction costs and their determinants (including the law). Although this is a positive statement, it has been often interpreted as a normative one, which explains part of the controversy on the Coase Theorem.

In this essay, I want to put normative law and economics in perspective. I will start from the distinction between positive and normative analysis, because this has marked different approaches to EAL historically. Although the distinction is relatively straightforward from a methodological standpoint, the boundaries between positive and normative law and economics become

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2 Law and economics is shorthand for Economic Analysis of Law, which, particularly among legal scholars, is often abbreviated as EAL. In this essay, I shall use the two expressions interchangeably.

blurred when we engage in the analysis of a particular policy problem, which is what most law and economics scholars, including myself, typically do. This is one of the reasons why law and economics has been controversial among legal scholars. EAL borrows from economics powerful methods for analysing the impact of different legal rules on individual behaviour. Unfortunately, these methods are not as good to define what a community of individuals wants, for the simple reason that economics does quite a poor job at aggregating the preferences of the members of society (Arrow 1951). Does this imply that law and economics should refrain from normative statements?

Two arguments are usually deployed against normative law and economics. First, we may genuinely not know how to maximize the well-being of a certain society and hence, what the best rules for this society are and how to implement those effectively. Call this set of knowledge issues the *policy problem*. Second, even if we knew how to solve the policy problem, interests other than the pursuit of society's well-being could still drive the lawmaking process. Call this the *political economy problem*. These are two powerful criticisms to normative law and economics. On the one hand, the limited knowledge of environmental preferences of current and future generations makes it impossible even for a conscientious lawmaker to establish the optimal level of, say, CO_2 emissions of automobiles. On the other hand, because lawmakers cannot be trusted to be conscientious and always act for the interest of society, the outcome of environmental, safety as well as any other regulation is largely determined by the influence of the constituencies (e.g. lobbies) best positioned to satisfy the private interest of lawmakers. The answer to these concerns in law and economics is often a pragmatic one. Because laws and regulations exist and they matter for economic outcomes, normative analysis, however limited, is worthwhile if only to improve economic performance. Being aware of the above limitations, though, is crucial for the success of normative law and economics.

Although economics is sometimes unable to support final judgments about the desirability of legal rules, law and economics can inform policymakers about which legal regime is efficient under different circumstances. As I will show, there are several definitions of efficiency, depending on how we tackle the problem of preferences aggregation. And law can pursue goals other than efficiency. Choosing among these goals is not the job of (legal) economists who take pride in refraining from value judgments.[3] What legal economists are good at is showing costs and benefits of policy options. For instance, monopoly is allocatively inefficient because it artificially restricts output. Moreover, it redistributes wealth from consumers to producers. However, monopoly can motivate innovation and innovation makes monopoly unstable. Law and economics cannot (and doesn't) make the case for prohibiting monopoly. However, it can inform lawmakers about the benefits and costs of regulating monopoly in certain industries. Real-world policy choices are even more

[3] Since Lionel Robbins (1932), the economics profession largely refrains from judgments based on external values (such as ethical values), particularly when they imply interpersonal comparisons of utility. Whether economics can be entirely value-neutral – notably in the context of policy analysis – is, however, debatable. See Mongin (2006).

complicated than this stylized example. An anecdote about U.S. President Harry Truman is that he asked to be sent a one-armed economist to avoid receiving advice in the form: "On the one hand, this. On the other hand, that." This anecdote captures the strength and limitation of the economic approach to law. On the one hand, it can provide rigorous information about the economic consequences of certain rules. On the other, it cannot unambiguously determine which rule is the best under all circumstances.

Similarly, knowing that lawmakers are self-interested is a good starting point for designing the lawmaking rules in such a way as to align as much as possible the lawmakers' incentives with the interest of the society. This is the domain of political economy. Law and economics is not only sceptical about the motivation of policymakers to maximize social welfare (positive analysis); it also seeks to design legal institutions that will produce rules aiming to maximize social welfare (normative analysis). Short of the difficulties to identify welfare maximizing solutions, this approach – known as Constitutional Political Economy (CPE) – also leads to policy recommendations framed as trade-offs. For example, subjecting regulatory agencies to bright-line rules is useful to control a bureaucracy and to police corruption, but may make regulation quickly obsolete. On the other hand, regulatory discretion can promote more adaptive and efficient regulation only if law and complementary institutions put regulatory agencies on a proper incentive scheme.

As a final step towards the identification of the normative character of law and economics, I will focus on the *dynamics* of the economy and the law. Whether it is better for society to have a larger pie divided in unequal slices (more efficiency) or a smaller pie more equally divided (more equity) is debatable and economics is unlikely to have the last word in this debate. Law and economics faces the same limit. However, the case for economic growth is much stronger than the one for static efficiency. At a constant growth rate of 2% the income of a country will triple in about 55 years. So, in little more than a working generation, we will be no longer discussing how to divide one pie in order to preserve the incentives to produce it as large; we will be speaking about three such pies! (At a growth rate of 5% the pies become 15). Some members of society benefit from economic growth more than others, but very few are net losers. Conversely, the shrinking of an economy harms the vast majority of its members while making very few winners. Although there is hardly any reason why the gains of the few who profit from lower growth – typically the *rentièrs* of the status quo – should be more important than the losses of the many who profit from higher growth, the former usually have the power to resist efficient legal change (Cooter & Schäfer 2012). This circumstance makes the normative goal of economic growth interesting for law and economics.

One recent finding in economics is that law "matters" for economic growth (Hall & Jones 1999). This has spurred a significant body of research aimed at identifying the legal determinants of growth. Normative law and economics has evolved from a static to a more dynamic analysis of the efficiency of legal rules, focusing on the questions whether certain rules support economic growth better than others and how the production of growth-promoting rules can be encouraged. Also this approach can be divided into policy analysis and political economy. The policy analysis asks the question which rules foster economic

growth. Although this is formally a positive question, answering it can inform a broader normative analysis given the desirability of growth also for purposes other than efficiency. From a political economy standpoint, the relevant question is what makes growth-promoting changes of the legal system happen. Here the normative analysis is less straightforward. Not only is the positive question particularly difficult to answer, but also policymaking faces severe limitations in influencing legal change for the good. Still, this influence is possible and ultimately motivates the law and economics enterprise.

The success of law and economics can be measured from the influence that EAL has had on legal education. Paralleling the internationalization of legal education in the past few years, the impact of law and economics on the legal professions and policymaking worldwide has increased, becoming an important driver of legal change (Milhaupt & Pistor 2008). Moving focus from static to dynamic efficiency is a change in perspective not even comparable to the inclusion of efficiency in legal analyses in the first place. Yet, the awareness of the limitations of economic tools in answering policy questions has ultimately made law and economics successful in shaping legal thinking. Economics can help answer some questions about legal policy – e.g. which regulation of the market for corporate control is efficient – with higher confidence than others – e.g. how to prioritise the use of scarce healthcare resources. Moreover, as the experience of the recent financial crises shows, economics may focus on a too narrow set of questions. The ability of economics to explain and improve on real-world phenomena may be sacrificed to analytical tractability, leading to a "pretense-of-knowledge" syndrome (Caballero 2010). This attitude has been reflected by the high degree of abstraction in the law and economics modelling of the past few years as well as by the neglect of important, but so far analytically intractable phenomena, such as endogenous financial instability (Minsky 1986) or macroeconomic uncertainty (Keynes 1936).[4]

In the remainder of this essay, I shall argue that law and economics can be effectively normative if it *asks the right questions* about legal rules. The right questions are those that economics can answer better than other disciplines because they involve mainly, if not exclusively, a judgment of economic efficiency. However, because there are several definitions of efficiency and choosing among them is inevitably controversial, law and economics should focus on efficiency that can be framed as measurable economic outcome. One such outcome is economic growth. I will contend that law and economics should pursue economic growth because this is arguably instrumental to several other dimensions of society's well-being – about which, however, economics cannot conclusively recommend a choice. Finally, as experience shows that growth-promoting rules vary with context and over time, law and economics should be cautious about one-size-fits-all approaches and rather identify the legal solutions that fit and can be better developed in each institutional environment.

[4] Both problems have been noted by Posner (2010), who attributes them largely to the influence of mainstream economics on the peer-review of law and economics scholarship.

II. A Brief History of EAL

Being instrumental to establishing how the EAL has come to normative analysis, the following discussion will not do justice to the many scholars who contributed to law and economics. Interest in the economic effects of law existed before Ronald Coase (1960),[5] but the diffusion of law and economics as we know it started with the publication of *The Problem of Social Cost*. Short of the controversy surrounding it, the Coase Theorem contains a simple message to lawyers and economists: Do not neglect each other. Expanding on a point he had made over 20 years earlier (Coase 1937), Coase demonstrated to the economists that the market's failure to maximize welfare could only occur if the cost of using the market mechanism was high enough. Because this is normally the case, law has an impact on efficiency (on top of several other things). This was the message to the lawyers too, delivered through examples of how common law affected economic efficiency. The article, however, was interpreted differently. Mainstream economists essentially ignored the message and still refer to the Coase Theorem as the ability of markets to self-correct (which sometimes markets do have). Legal scholars at Chicago took stock of Coase's examples to argue that common law naturally evolves towards efficiency.

Following Coase, the Chicago school of law and economics maintained a positive approach. But law and economics did not have to be confined to positive analysis. At Yale, Guido Calabresi (1961) had developed a normative economic approach to law independently from Coase. The gist of Calabresi's work was that the goal of tort law *should* be to minimize the cost of accidents and that liability rules *should* be chosen accordingly. With his examples, Coase showed instead *how*, in the presence of transaction costs, common law minimized the cost of nuisance and trespass assigning the right to use scarce resources. The two approaches are obviously complementary, as subsequent systematization of the law and economics matter showed (Cooter & Ulen 1988). But this is not how law and economics became a successful approach for legal analysis.

Richard Posner contributed more than others to the spreading of law and economics thinking by presenting economics as a rigorous, but straightforward way to *understand* the law as it was and not to recommend how it *should* be. Posner happened to be a lawyer in a system, the common law, which tended to favour decentralization and small government, as both the earlier (Hayek 1960) and the subsequent literature (Glaeser & Shleifer 2002) on legal origins argued. As Posner (1990) made clear later, he favoured these things too. This is a normative judgment that was and still is, unsurprisingly, controversial. I will return to it in the next section. However, the fact that Posner initially refrained from normative analysis arguably explains much of the success of law and economics in the U.S.

[5] Precursors include, among others, John Commons (1924), Robert Hale (1952), Aaron Director – "the intellectual progenitor of what is sometimes called the 'Chicago School' of antitrust policy" (Pelzman 2005:313) – and the Ordo-liberals (Böhm, Eucken & Grossmann-Doerth 1989).

Appealing to lawyers' demand for a unifying theory of law (Veljanovski 2007), Posner enabled a major change in the perspective of legal thinking: The move from ex-post reasoning to ex-ante reasoning. This is the key difference between the traditional legal approach and the economic approach to law. For lawyers, a legal rule is important to resolve disputes *after* some contested action has taken place (ex-post perspective). For economists, the important issue is how legal rules affect *future* actions by providing incentives (ex-ante perspective). Traditional lawyers want to punish criminals and make injurers compensate their victims. For economists, crime and damages that have already happened are a fait accompli. The incentives to commit crime or to do damage affect the levels of social harm, whereas punishment and damage compensation, however just, cannot undo the harm already occurred to society. The economic approach did not challenge crime punishment or damage compensation, only made these and other legal remedies instrumental to deterrence.[6]

It is a small step between thinking of legal rules like an economist and normative law and economics. Why would one intervene in markets and alter their outcomes with coercive or quasi-coercive instruments (some legal rules, particularly in contract law, allow for opt out) if that wasn't for the good (Coleman 2003)? Recognizing the validity of this point, Posner (1980) eventually engaged with the question why efficiency should be a goal of the law. On the other hand, Guido Calabresi and the Yale school of law and economics had always argued that law and economics *had* to be normative. However, from this perspective, efficiency was only *one* of the many goals of the law (Calabresi 1980).

Calabresi's work shows an important limitation of normative law and economics. Efficiency is not always enough to identify the best legal rule. Quite often, however, it is. For instance, following Coase, Calabresi & Melamed (1972) argued that conflicts about the allocation of scarce resources should be resolved by property rules (allowing for resource entitlements to be exchanged exclusively by mutual consent) when transaction cost are low, and by liability rules (allowing for unilateral compensation of the entitlements' value) when transaction costs are high but nonetheless, the value of entitlements is known or can be estimated. Accidents between automobiles, whose cost cannot be reasonably minimized by bargaining between the numerous parties potentially involved, are a good example wherein liability rules are efficient according to this framework. Theft, on the contrary, is efficiently policed by a property rule – criminal law instead of tort law[7] – because theft undermines the security of property rights for the entire society whereas the transfer of property between two consenting parties can be bargained for at a low cost. Chosen appropriately, property rules and liability rules can guarantee that scarce resources flow to the individuals that value them the most. As we will see in the next section, such an efficiency characteristic is sufficient to make a legal rule desirable in a number of situations.

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6 The idea that punishment of wrongdoing should aim to deterrence has an older ancestry (Beccaria 1764; Bentham 1789) than law and economics.

7 This perspective importantly differs from Becker's (1968), which, focussing exclusively on deterrence, cannot really distinguish between tort and criminal law.

Society, however, sometimes faces "tragic choices" that cannot be made on the sole basis of economic analysis (Calabresi & Bobbit 1978). Valuing human life is one important example. On grounds that life is priceless, Calabresi and Bobbit argued against market allocations to solve problems like kidney transplants, where the available resources are insufficient to save everybody's life. Despite Jules Coleman's being one of the most vehement critics of law and economics, Coleman & Holalan (1979) responded that this approach mistakenly disregards an important asset of the market mechanism. Market prices provide information about the cost of alternative choices. However founded, this criticism misses the essence of Calabresi's point. Economic analysis can indeed *inform* policymakers about the costs of kidney transplants illustrating the trade-off with other scarcities. But economics cannot *decide* how many lives to save by means of kidney transplant as opposed to cancer treatment because economics cannot reliably compare the value of life to the individuals affected by the two diseases (and it cannot make several other interpersonal comparisons of utility). Therefore, another way to frame Calabresi's point is that policy choices cannot be delegated to one-armed economists. Still, policymaking can profit enormously from the economist's insights into the costs of alternative options to society. Sometimes, this is enough to decide. Some other times, it isn't.

Chicago school's insistence on the superiority of common law reveals another important limitation of normative law and economics. Posner (1973) initially argued that common law judges have incentives to produce efficient doctrines in order to increase their prestige in society. This was contrasted with the forces shaping the production of legislation. Because of the pressure by interest groups, these forces are more concerned with the distribution of wealth than with its maximization. Hence, statutory law could not be trusted to be efficient, whereas judge-made law could. Rubin (1977), Priest (1977), and Landes & Posner (1979) tried to reinforce the argument on grounds that the process of adjudication in common law resulted in the selection of efficient rules because inefficient ones are more often litigated and eventually, overruled. As Rubin (2005:21) later admitted, these models failed to demonstrate the efficiency of particular common law doctrines, "perhaps because the law is not so efficient as Posner argued."[8] Yet, this discussion shows that law and economics had been always concerned with the flaws in the production of law.

Normative EAL must thus reckon that the production of law is not always driven by efficiency, but also by other considerations affecting the interest of lawmakers – whoever lawmakers are. These considerations may include a genuine concern for society's well-being, but they are not limited to it both because policymakers may not know how to maximize this well-being and because their self-interest may conflict with that goal. Posner's understanding of common law was rightly criticized on grounds that this problem affects not only legislators, but also judges. The latter are usually not trained in economics

[8] This outcome must be contrasted with Hayek's (1960) intuition that common law was overall more market-friendly than civil law. As I discuss below, the literature stemming from this intuition had more fortune.

and, depending on the jurisdiction where they operate, may have interests diverging from the pursuit of efficiency in society.

When law and economics spread outside the U.S., the different approaches to it came conflated with one another. Particularly the distinction between the normative and the positive school of law and economics has faded. Today, it is normal to distinguish between a *policy view* and a *political economy view* (Kornhauser 2011).

The policy view seeks to identify the best rules to discipline the interactions between individuals in various contexts (ranging from car driving, to contract, to corporate governance). It faces two problems that can be traced back to the previous debate. First, what is the goal being pursued? In EAL, this goal is normally economic efficiency. However, there are several definitions of efficiency, not all of which are acceptable to lawyers, particularly in certain contexts. In order to be effective, normative law and economics must focus on situations where economic efficiency is unambiguously desirable for society and specify which definition of efficiency better captures this effect. The second problem with the policy view of law and economics is that the normative implications are as good as the positive analysis underlying it. Theories about how law affects economic incentives are abundant and sometimes conflict with one another. Not all of them are borne out by the empirical evidence. Even the theories that are empirically supported in one context, may just not work in another context. In other words, after having settled on the goals of legal policy, our knowledge about how legal rules affect outcomes may still be too limited to achieve those goals.

The political economy view points to another challenge. Because politicians, bureaucrats and public officials are in general self-interested, policies may fail to achieve efficiency even when this is desirable and it is known how to do it. This result holds equally true under the more nuanced approach to self-interest supported by behavioural law and economics (Korobkin & Ulen 2000). Even though policymakers were more conscientious and less boundedly rational than the average individual, which is hard to prove empirically, they would still depend on others to figure out what society's well-being requires. However, the forces behind lawmaking care more about the distribution of existing wealth than about efficiency in a static (wealth-maximizing) or in a dynamic (growth-maximizing) sense. At every point in time, the production of law is affected by the constituencies that are better positioned to influence the producer, for instance by providing information to the regulator (capture) or by mobilizing the political support for a particular party (lobbying) (den Hertog 2012). These constituencies will oppose efficiency-enhancing policies that redistribute wealth away from them and, whenever this is feasible, will promote favourable redistributions that undermine efficiency. This is called the "Olson problem" after the influential work of Mancur Olson (1971; 1982) on collective choice. 'Radical' political economy (Kornhauser 2011) has long maintained a positive approach to this problem, arguing that the forces shaping lawmaking are exogenous and thus, their effect could only be studied, not improved. This has changed more recently (Voigt 2011). Following the approach by James Buchanan (1987), Constitutional Political Economy has become a normative enterprise. The rules of the game that can be agreed upon unanimously are

deemed efficiency enhancing. The mission of CPE is to identify the optimal design of lawmaking institutions fulfilling this criterion.[9]

This historical excursus of law and economics illustrates three problems with normative EAL. First, efficiency is not always sufficient to choose among legal rules. Second, our knowledge of the effects of legal rules may be too limited to achieve efficiency. Third, the incentives underlying lawmaking may undermine the quest for efficiency. As I am going to argue, choosing an appropriate definition of efficiency can contribute to the solution of all of these problems.

III. Efficiency versus Equity

Efficiency is an intuitive concept. The endowments of individuals and societies are limited. Efficiency means making the most out of those. More technically, (allocative) efficiency commands that scarce resources flow to their most valuable use. 'Valuable' is a tricky expression, though, because different individuals value the same things differently and their valuation may change over time. Uncertainty complicates this even further. A technological change in the relative scarcity of resources is undoubtedly 'valuable' (both in a positive and in a negative sense), but this value cannot be appreciated with precision ex-ante. Innovations such as cars, TVs, and the Internet represent such changes. The economic impact of these products can be appreciated now and is influenced by laws promoting or restricting their use, but this could not be fully anticipated at the outset.

Therefore, the concept of efficiency depends on how we measure the value of resources. One way to do this is (expected) *utility*.[10] An allocation of resources is efficient if it maximises the utility of all the individuals of a society. A problem with this approach is that utility can't be measured, although individuals may reveal a ranking of utilities (preferences) through their choices. Such individual rankings are not comparable. Another way to measure value is *wealth*, which makes efficient the allocation of resources that maximises it. The advantage of this approach is that wealth can be measured and compared interpersonally. This is also the disadvantage of this criterion, because for the purpose of wealth maximization it does not matter who ends up being rich and poor in society. A third way to define value – and the last one I will consider in this essay – is the *growth* of wealth. This is a dynamic efficiency criterion that commands allocations of resources to the individuals that can make the *productivity* of society grow. Defining efficiency in terms of growth can overcome the distributional objections to the wealth criterion by making nearly everyone better off. However, it can only do this ex-post, not ex-ante. Ex-ante, only the losers from a growth option stand out, whereas it is not known who the winners will be – they might not yet be born. Despite the uncertainties surrounding growth, it is, differently from utility, measurable. And promoting growth leads to more acceptable distributional consequences than promoting

[9] According to Parisi (2004), this approach characterizes the modern "functional law & economics," whose normativity is strictly based on methodological individualism.

[10] *Homines economici* are credited with rational expectations, allowing them to attach utilities also to future consumption. See Pacces & Visscher (2011).

wealth, because only those who do not adapt to the new technologies will eventually lose from economic growth – typically, but not exclusively, the *rentièrs* of the status quo.[11]

Efficiency criteria are not equally suitable for policy analysis. The Pareto criterion, which is based on utility, is the most intuitive. A move is a Pareto improvement if at least one individual is better off while no other member of society is worse off. Any situation that does not allow for Pareto improvements, typically because one or more members of society would lose from change, is Pareto efficient. The Pareto criterion has the big advantage to define efficiency *without* calling for interpersonal comparisons of utility. The tricky question whether the gains of winners are worth more than the losses of losers can be avoided because, for a move to be a Pareto improvement, no one can lose anything. However, this requirement is also a limitation. Any member of society can veto a move that would make all of the others better off, if this move reduces, however little, her well-being. Moreover, depending on the wealth distribution one starts from, market exchange can result in infinite Pareto-efficient situations that are incomparable with one another.

The Pareto criterion is largely unhelpful for policymaking. In perfectly working markets, moves satisfying the Pareto criterion occur spontaneously allowing the economy to reach the maximum amount of production given the available resources – the so-called *production possibility frontier*. We might not know how to compare different Pareto optimums not knowing the distribution of wealth that the society favours, but we could cope with this problem by hypothesizing some social welfare function in the shape of Rawls (1971) or Nash (1950), for instance. The raison d'etre of law and economics, however, is that the production possibility frontier is *not* reached because of some market failure. Resources are misallocated because individuals fail to conclude mutually beneficial exchanges (Coase 1960). This implies that society lies at some point *below* the possibility frontier, although the Pareto criterion has not been violated (or precisely because of that). Normative law and economics would consider efficient a legal rule that allows the society to move closer to the frontier. Obviously, the Pareto criterion cannot help to achieve this outcome because if it could, the outcome would be already achieved (Calabresi 1991).

To avoid the rigidity stemming from the Pareto criterion, law and economics has been using the Kaldor-Hicks criterion.[12] According to this criterion, a move is efficient if the winner could compensate the losers and would still be better off. Because the winners do not have to actually compensate the losers this is also called the 'potential' Pareto criterion (Calabresi 1991). Kaldor-Hicks efficiency is notably problematic because the criterion allows for redistributions that, in the extreme, cannot be considered welfare increasing – like the transfer to the wealthiest member of society of the only asset owned by the poorest member of society. Moreover, the criterion assumes that wealth gives the same utility to the rich and to the poor, which cannot be true. That being said, the Kaldor-Hicks criterion allows for policies moving society closer to the production possibility frontier, which would not be possible if we stuck to the

[11] The cost of adaptation may have to be compensated ex-post, but as I hint below, growth allows for large means for redistribution.

[12] See Hicks (1939), Kaldor (1939) and Scitovszky (1941).

Pareto criterion. For this reason, the Kaldor-Hicks criterion has been particularly useful for policy analysis. However, the limitations of this criterion reflect upon normative law and economics.

There is a conflict between efficiency and equity, however we define the latter – and defining it is *not* the job of economists. Equity can include several notions of justice – corrective, retributive, distributive – all of which may be at odds with efficiency. The potential conflict between efficiency and corrective and/or retributive justice is apparent when we look at tort or criminal law from an economic perspective, according to which harm is a sunk cost and cannot be undone.[13] More important, legal rules have distributional implications also ex-ante. It would be illusory to ignore them in the quest for efficiency, primarily because of political economy, which as a matter of positive analysis deals exclusively with distribution. But also for policy purposes, arguing that efficiency should be pursued *regardless* of the distributional consequences is highly objectionable. The argument that efficiency should be pursued *separately* from a redistribution agenda can be better justified. First, because economics does quite a poor job in aggregating individual preferences, economists usually do not know what is the equitable or just distribution of wealth in a society – economists can only speculate on that. Second, economics makes it intuitive that one dollar is worth much more to the poor than to the wealthy – however, because economics cannot tell how much more, this intuition is of little use. Third, because redistribution is not costless, the interesting question is not *whether* to redistribute, but *how* to do it. Tax policy is usually preferable to tampering with the efficiency of legal rules. Redistribution, whether via taxes or legal rules, undermines the incentives to work hard in order to produce wealth. However, redistribution via legal rules may further reduce wealth if it fails to correct market failure (Georgakopoulos 2005).

On this basis, Posner (1985) has argued that EAL should focus *exclusively* on wealth maximization. The most powerful part of Posner's argument is that wealth is an objective goal and it is measurable, both of which are useful to cope with the knowledge issues underlying the policy problem and to discipline policymakers (the political economy problem). The most questionable part of Posner's argument is, instead, that law should avoid redistribution. Later on, Posner (1990) clarified his position as one of a pragmatic libertarian, aware of the impossibility of making this world ideal and sceptical of big government's ability to improve it. Although from an economic perspective this is a value judgment, the philosophical grounds of this position are worth discussing briefly.

According to Posner, the goal of wealth maximization reflects a *work ethic* in which individuals are entitled to keep what they produce thus having incentives to produce as much as possible. Posner has argued that such an ethic would be agreed upon if people did not know whether they are born with human capital (hence with a higher chance to become wealthy) and this circumstance was entirely random. For this reason, law should not redistribute, but only maximize wealth by correcting the market's failure to do so. For instance, it should not matter for tort law whether a strict liability rule inducing optimal

[13] See Coleman & Mendlow (2010).

behaviour of the injurer harms the richer or the poorer because, ex-ante, individuals are equally likely to be injurer or victim.

Posner's argument is open to criticisms. To mention one, individuals are not randomly affected by wealth-increasing reallocations of entitlements. In some contexts – for instance education, healthcare, but also traffic accidents – it may well be that wealth-increasing rules systematically disfavour the poorer. For instance, think about safety regulations of car manufacturing: These make cars less affordable and more dangerous for pedestrians as drivers of safer cars will take less precaution. Knowing that being poor reduces, however little, the chance to become rich in the future, individuals may plausibly prefer a more egalitarian distribution of wealth (Rawls 1971).

Roughly twenty years later, Kaplow and Shavell (2002) attempted to beef up the philosophical grounds of normative law and economics by departing from the wealth criterion and choosing a utilitarian concept of welfare. Their key point is that moral concerns for equity, or fairness, should be included in a definition of social welfare as aggregation of fully informed preferences of society members. If pursued separately from welfare, fairness reduces the well-being of society. Therefore, law and economics should maximize welfare and disregard notions of justice external to welfare.

Kaplow and Shavell have attracted as much criticism from legal theorists as Posner (see Coleman 2003). Because I find the debate on the morality of law and economics sterile, I shall not further elaborate on this. Economic analysis cannot answer the question whether legal rules are *moral* – neither is economics supposed to do this.[14] The goal of (normative) law and economics should be to answer the question whether legal rules are *efficient*. What makes economics a powerful tool to answer that question is that economic outcomes can be *measured*. Therefore, for purposes of policy analysis, wealth is a better way to make efficiency operational than welfare, which is hard to measure.

Under the approach I am proposing, normative law and economics works better in some contexts than in others. For example, the distributional downside of the Kaldor-Hicks criterion is not so much of a concern in business law as in family or consumer law. But, even in those contexts where distribution is clearly more important for society, law and economics should not try to incorporate distributional concerns into an abstract notion of welfare. The normativity of economics *qua economics* is limited to the maximization of measurable outcomes, namely outcomes that can be valued in terms of relative scarcity – observable prices. Hence, normative law and economics should focus on the maximization of wealth, flagging, but not even attempting to resolve, the distributional consequences of this maximization. In other words, *the efficiency and the distributional consequences of policy options*

[14] It may be objected that economists have sometimes embarked in this endeavour. One prominent example is Amartya Sen (1999), arguing that per capita income is not enough to characterize economic development, which should rather include quality of life, education, and freedom. However agreeable, these are value judgments. The subtler question is to what extent normative economic analysis is possible without value judgments (Mongin 2006).

should be presented separately. In many contexts, particularly in business law, efficiency and distributional issues can also be *treated* separately.[15]

In one set of situations, framing the normative law and economics question as wealth maximization allows identifying efficient legal rules without compelling distributional objections. These are the situations affecting *economic growth*. It is hard to argue against economic growth. Growth means more of everything we may possibly want. Technically, growth is a shift of the production possibility frontier depending on improvement in some technology,[16] allowing for more consumption also of the goods not affected by the change in technology. Think of manna. Not having to spend money on bread, people can spend more on entertainment. Because of this simple intuition, law and economics scholarship has gradually converged towards the quest for economic growth. Interestingly, this process has been independent on the commentators' views about redistribution and what law and economics should maximize. Calabresi (1991) has been a pioneer in advocating the shift of law and economics towards the promotion of economic growth. But he was recently joined by Posner (2010). Two major reasons for this convergence are that growth has proven a major instrument to fight poverty (Cooter & Schäfer 2012) and that growth provides both incentives to be productive and means for redistribution of a greater order of magnitude than the efficient reallocation of existing resources (Cooter & Edlin 2014).

Sceptics may object that growth is not always desirable. There is, for instance, a large debate on 'sustainable' growth. According to a long-standing position in this debate, growth ought to be stopped in order to save the world from self-destruction (Meadows et al. 1972). Because sustainability is a vague notion, economists refrain from discussing it as such. Economics worries about depletion of resources (Hardin 1968). Depletion is a negative externality, namely an adverse consequence of market transactions on people not involved in the transactions. This depends on the social cost of certain resources (e.g. fossil fuels) being higher than their price. When transaction costs are too high for markets to bridge the gap – as in the case of global environment – law and economics recommends regulatory intervention. However, economics is agnostic about how to divide the burden of environmental regulations across generations. Assuming an exogenous production technology, Nordhaus (1994) and Stern (2007) have shown that there is a trade-off between economic growth (benefiting the current generations) and environmental disaster (dooming the future ones). This trade-off could only be resolved based on value judgments. Yet, fortunately, technology is endogenous and evolves with growth. In this perspective, environmental regulation can minimize the slowdown of economic growth by *directing* innovation towards non-depletive technologies (Acemoglu et al. 2012). Depletion of resources does not necessarily depend on economic

[15] Contrary to a widespread belief, efficient takeover rules do not increase the likelihood of layoffs, which can happen independently of takeovers. See Enriques, Gilson & Pacces (2014).

[16] This holds true assuming that the economy is already producing at the frontier, implying that no mutually beneficial exchange is foregone due to market failure.

growth. To the contrary, growth-oriented regulations can avoid depletion at the least cost.

Obviously, growth is not manna: It needs to be bred. Growth economics shows that *productivity* is the key determinant of growth (Solow 1957). Recent research shows that law significantly affects productivity in a number of ways. The challenge for modern law and economics is, therefore, twofold. The first is to identify which laws matter for economic growth and how. The second challenge is to engineer reforms resulting in efficient law. As I am going to illustrate, the character of these challenges makes the case for focusing on the maximization of wealth even stronger. On the one hand, the measurability of performance can help identify the effective impact of legal rules on growth, which is particularly important when uncertainty is high as in every case of innovation. On the other hand, the availability of performance measures can help commit policymakers to promoting economic growth, despite the pressure of interest groups to maintain the status quo on grounds of redistribution (to themselves).

IV. Law (Finance) and Economic Growth

What is the law that matters for economic growth and how do we get it? I am arguing that normative law and economics should focus on these questions in order to maximize its impact on policymaking. Such a focus would allow law and economics to deal with the policy problem more effectively and to overcome the resistance of the ruling elites to efficient legal change. This conclusion depends on the ability of law and economics to determine the impact of laws on economic growth *objectively*. Measurability of policy outcomes allows disciplining both theorists, with respect to the means to achieve certain ends, and policymakers, with respect to the ends underlying the choice of means.

Economics has long reached the conclusion that law 'matters' for economic growth but so far, what precisely matters and how is not yet settled (Beck 2010). To be sure, theory is relatively straightforward. To support economic growth a legal system should protect property rights, notably including intellectual property rights, and guarantee a reliable enforcement of contracts. Implicit in this literature is the importance of public law, not only for reliability of enforcement, but also because sometimes regulators have better incentives to correct market failures than judges (Glaeser et al. 2001). Growth-promoting laws preserve the incentives for entrepreneurs to engage in innovation. If successful, entrepreneurs will be entitled to retain the lion's share of the gains. Although most economists would stop at this point, here the problem becomes interesting for legal analysis. Relevant question are what kind of contracts are important and what are the costs of drafting them; how these contracts should be enforced particularly in the face of unforeseen circumstances; how property rights should be defined and protected especially when they become the source of economic rents (monopoly power) or other market failures (negative externalities). Short of the detailed answers to these questions, each of which would deserve a separate essay, one meta-question is whether a single

answer is warranted, namely whether there is a single set of legal rules to promote economic growth independently of context or else different contexts (jurisdictions) call for different rules.

The argument that one-size-fits-all rules are efficient has a long tradition in law and economics (e.g. Shavell 2004). In the law and growth literature, though, the debate started from Hayek's (1960) observation that the common law tradition of constraining government intervention in markets was better suited to supporting the incentives of a market economy. This proposition, which is different from Posner's defence of common law's efficiency, was tested empirically and apparently, data supported it. In the 1990s, a group of American economists known as La Porta et al. published a series of influential articles in which they showed that legal rules of various kinds (for instance, company law, bankruptcy law, securities law, labour law, antitrust) affected economic performance as measured by several indicators. La Porta et al. pioneered a method and on its basis, they defended a thesis. The innovative method consisted in measuring the quality of law based on assigned scores (so-called 'coding'). The thesis, which was not as novel, was that legal origins mattered and particularly, that countries belonging to the common law tradition were performing better than other legal origins on a number indicators of economic and financial performance. Both the methodology and the thesis have met with extensive criticism, despite having marked an important step in the evolution of law and economics.

Because this literature started as *Law and Finance* (La Porta et al. 1998), I will discuss its contribution and limitations with reference to corporate governance and financial regulation, which are the fields I am most familiar with. However, the recent focus of law and economics on growth includes more than finance, although for dynamic efficiency some areas of law (e.g. constitutional law and law enforcement) intuitively matter more than others (e.g. tort law and consumer protection).

A key achievement of law and finance is that laws and their impact on financial institutions can be 'measured,' which is very important for making comparisons. It is also interesting to know that the common law legal origin correlates with higher investor protection, which, in turn, correlates with higher performance of certain financial markets.[17] However, the work by La Porta et al. has not proved that there is a *causal* relationship between these things. To be sure, Klick (2010) has powerfully argued that such a broad causality could never be proved. The credibility revolution in econometrics (Angrist & Pischke 2010), which informs the recent trend of empirical studies in law and economics, is based on the availability of counterfactuals. Because civil law countries are not identical to common law countries apart from their legal tradition, it is impossible to identify which factor underlying legal tradition is responsible for varying economic outcomes. Empirical legal studies are still a good method to improve our knowledge of how law affects finance and growth. To this purpose, however, two major weaknesses of the literature on law and finance and legal origins must be remedied. First of all, the measurement of

[17] As surveyed in Pacces (2012, pp. 54-61), this finding has been criticized on several grounds, questioning particularly the coding of laws, the division of countries among legal origins, and the significance of the latter for corporate law.

institutions – notably including the law – must be improved. So far, the coding of laws has been largely based on statutes and surveys, which provide a much too coarse account of how legal rules work in reality, combined with complementary institutions (Voigt 2013). Secondly, in order to ascertain causality, the impact of laws must be tested paying more attention to the counterfactuals, for example focusing on staggered legal changes within a country or a group of comparable countries (Beck 2010).

The argument that legal origin determines economic performance was eventually tempered down. La Porta et al. (2008) clarified that the common law tradition to sustain markets rather than replacing them by government intervention is neither immutable (although it is persistent) nor is always the best way to support economic performance. In their view, market-harnessing legal institutions are best suited to economic growth in quiet times, whereas a more centralized approach to regulation is efficient in times of economic disorder.

It is a small step between this conclusion and acknowledging that the efficient legal rules supporting economic growth vary with context. Take again finance as example. Empirically credible research shows that finance is a major channel through which institutions affect growth, and importantly, a channel that provides opportunities *for everyone* thus overcoming, at least ex-ante, conflicts between efficiency and equity (Beck 2013). Finance, however, can take different forms and likewise different are the legal rules that support, say, stock markets as opposed to relational banking. More important, different kinds of finance suit different industries and different stages of development. Therefore, the most efficient law for finance (and growth) is the one best fitting the needs of the local industries. Investor protection is only one dimension along which the fit of legal rules must be evaluated. Particular companies in particular countries may need less commitment towards investor protection, for instance because this is supported by extralegal institutions, but more freedom to develop innovative ideas. Failure of the legal system to support an optimal balance between flexibility and commitment can result in suboptimal corporate governance choices (Pacces 2012) or strategic responses making investor protection ineffective (Milhaupt & Pistor 2008), both of which undermine economic growth.

If the legal rules to be regarded as efficient vary with context, most likely they vary with time too. Paralleling mainstream economics, the law and finance literature was initially silent about financial instability, suggesting that the legal rules promoting more finance (and hence more growth) were always to be favoured. The recent experience of financial and economic crises reveals, however, that there may be more finance than socially optimal because technically, finance has negative externalities (Beck 2013). What law can do to cope with this problem is not straightforward in a traditional perspective, given that financial markets are already extensively regulated. Following Keynes (1936), I have argued that uncertainty – which is significantly related with innovation and growth – can shed some light on which rules are dynamically efficient for finance.[18]

[18] See Pacces (2013) for an overview of my work on this topic.

Uncertainty makes economic growth more acceptable than static efficiency as a normative goal because the identity of winners from innovation cannot be known ex-ante. While one could argue that victims of traffic accidents are systematically poorer that the injurers, it is much more difficult to argue that successful entrepreneurs are systematically richer than unsuccessful ones so long as both have access to finance on equal terms. Uncertainty, however, has also adverse consequences on financial stability because it implies that risk, particularly systemic risk, cannot be precisely measured ex-ante, which is the reason why financial crises happen and need to be resolved ex-post. According to a theory which has become rather influential in the aftermath of the global financial crisis (Minsky 1986), financial instability is endogenous to a capitalist economy. This has several consequences on normative law and economics.

First, investor protection is important to promote finance and growth, but it is not enough. Legal rules need also to be concerned with the governance of crisis situations, in which the protection of investors may have to be relaxed to achieve ex-post efficiency (Pacces 2013). Second, although the law defines the terms of financial exchange, these terms are altered during financial crisis and importantly, flexibility is asymmetric. Political economy ultimately determines how financial commitments can be renegotiated ex-post (Pistor 2013). Albeit necessary, flexibility ex-post undermines the credibility of financial exchange ex-ante. For this reason a recent focus of both constitutional political economy and law and finance is, on the one hand, how to design coercion-constraining institutions to make governments' action credible and, on the other hand, how to provide policymakers having discretion to intervene ex-post with the incentives to care for long-term economic growth (Beck 2010; 2013).

The study of the dynamics of legal change faces a similar challenge. Even knowing which legal rules promote growth while containing financial instability, one would still be facing the political economy problem. To frame this problem, it is useful to look at it from two different angles. Consider first a well-minded legislator facing opposition by existing elites who benefit from the status quo. There are several strategies to overcome this problem. These include regulatory dualism (Hansmann, Gilson & Pargendler 2011), or reform with parallel regimes, one of which is designed to protect the elites' rents until these are eroded by the efficiency of the new regime. Another strategy is gradual reform (Dewatripont & Roland 1995), which aims at creating a constituency for change that will eventually outperform the resistance by vested interests. Because the legislators cannot be assumed to be well-minded, a second issue is how to align their incentives with the interest of society. Here a focus on measurable outcomes can be very helpful. Such outcomes may be used to commit legislators and policymakers to the goals they declare, for instance by making their political or monetary payoffs contingent on the achievement of those goals. Moreover, the measurability of economic outcomes allows overcoming the uncertainty about the causal effect of laws if policies are implemented with an experimental design (Abramowicz, Ayres & Listokin 2011). Unfortunately, some policies, particularly macroeconomic policy, can hardly be implemented with an experimental design (Angrist & Pischke 2010).

V. Conclusion

In this essay, I have discussed how economic analysis of law can be normative, namely inform lawmaking about which laws are desirable for society. I have argued that the effective normativity of EAL depends on asking questions that can be answered mainly, if not exclusively, based on efficiency. The quest for rules supporting economic growth is one such question. If this is arguably enough to temper the conflict between efficiency and equity, it still leaves us with a policy problem (which rules promote economic growth and how to implement them?) and a political economy problem (how can society actually adopt efficient rules?). To solve both problems, law and economics should maintain its focus on the measurability of outcomes. In this way, both theorists and policymakers can be disciplined by empirical evidence.

I have also argued that efficient legal rules vary with context and over time. Although the measurability of economic outcomes can inform too about the best fit of legal rules with a given situation, the question remains, who will promote efficient legal change when needed? I have no pretence to answer such a difficult question. But the economic analysis of law, via its influence on global legal education for about fifty years, has been undoubtedly one force behind legal change and will likely continue to be such for many years to come.

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