

# **Issues in Law and Economics**

**HAROLD WINTER**

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# Applying Economic Reasoning to the Law

One way to introduce the economic approach to the law (and social issues in general) is to think of economic analysis as involving three broad steps (see Winter 2013):

1. Identify the theoretical trade-offs of the issue in question.
2. If possible, empirically measure the trade-offs found in step 1.
3. Advise social policy based on steps 1 and 2.

Several brief examples from some of the issues presented in this book will help illustrate the key aspects of these steps.

## Theory

For every social issue you can imagine, there will have to be trade-offs, or costs and benefits, to consider. Sometimes, the key trade-offs are fairly obvious. Increasing the size of a local police force has the benefit of reducing the crime rate, but involves the costs associated with hiring more police officers (see chapter 10). Copyright law's most important benefit is that it can encourage the creation of intellectual property by protecting the creator's financial gains from being eroded by pirated copies. On the other hand, copyright law's most important cost is that it grants the creator some amount of monopoly power, possibly leading to higher prices that can exclude some consumers from purchasing the good (chapter 4).

Other trade-offs are more difficult to recognize, especially for the layperson. The three-strikes law, which punishes third-time criminal offenders

very harshly even for minor crimes, may lead to an increase in the murder rate (chapter 11). Medical malpractice law may induce doctors to increase the level of care they provide to their patients, even when this additional care does not improve health outcomes and is not recommended by the medical profession itself (chapter 9).

Step 1 is where economic analysis begins. Even for scholars who focus their research on the other two steps, there must always be some consideration of the trade-offs that are underlying the empirical work or policy analysis relating to whatever issue is at hand. Economists are trained to identify trade-offs that few others may ever consider. But how these trade-offs stack up against each other, and which ones are most relevant for whatever issue is being considered, ultimately requires some form of empirical verification and quantification. This leads us to the next step.

## **Evidence**

Some of the most passionate debates in the economic analysis of the law (and in economics in general) involve disagreement over the interpretation of empirical evidence. It is not uncommon to find a substantial body of evidence that supports a particular hypothesis, only to discover an alternative substantial body of evidence that refutes the same hypothesis. In trying to determine if sharing computer files is significantly hurting the music industry, the evidence is mixed (chapter 4). In trying to determine if racial profiling is an efficient policing technique in reducing crime or merely an indication of racially biased behavior among police officers, the evidence is mixed (chapter 12). In trying to determine if the death penalty deters murder, perhaps the most substantial debate in law and economics, the evidence is mixed (chapter 10). Why is there such a severe lack of a consensus among these empirical studies? There are several reasons.

Empirical analysis requires data, which can come from several sources such as surveys, observable market information, and controlled experiments. Unfortunately, data collection is often difficult to do and, as a result, data are often measured inaccurately. There can also be alternative ways to measure a single variable, leading to the issue of which measure is most appropriate to use. Furthermore, the real world is a big and complicated place to study; that is, for any given issue, there may be a large number of variables that are relevant for the analysis. As such, a lot of data that would be needed to accurately measure trade-offs simply may not be

available. Finally, and perhaps most important, there are many legitimate ways to approach an empirical analysis. Different statistical techniques and different ways to organize data can be used to test the same hypothesis. This variety of empirical methodologies inevitably leads to a variety of results.

There are also complications that are commonly found in empirical analyses that need to be taken into account. One such problem involves controlling for *confounding factors*. To determine if judges tend to sentence black men differently than they do white men, or sentence men differently than they do women, it is easy to compare average prison sentences across racial or gender categories (chapter 13). What you are very likely to find is that black men face longer sentences than white men, and men face longer sentences than women. But two obvious confounding factors (among several) that also influence the sentence length and must be taken into account are an offender's severity of offense and criminal history. If the group that faces the longer sentence also, on average, commits more severe offenses and has a more involved criminal history, it may be these factors that are the driving force explaining sentence length. It is important to note that these confounding factors do not preclude the possibility of judicial bias. Instead, controlling for these factors allows the researcher to have more confidence in attributing an effect to a variable of interest, such as judicial bias, as opposed to these other factors.

Another common problem found in empirical analyses is *reverse causation*. One simple prediction in combating crime is that if more police officers are hired, crime rates will fall (chapter 10). The causation, then, is that more police leads to less crime. On the other hand, it is also simple to predict that if crime rates increase, more police officers may be hired. The causation now is that more crime leads to more police. If this reverse causation isn't properly taken into account, a study that is trying to determine if the hiring of police officers is a sound approach to deterring crime may find that more police leads to *more* crime. Yet this result may be due to reverse causation, as opposed to a refutation of the prediction that more police leads to less crime.

These types of problems are well known to all but the least capable researchers, so they are rarely ignored in empirical studies. The real problem is that there can be disagreement as to which confounding factors matter most and need to be taken into account, and precisely how to correct for the problem of reverse causation. Along with the other problems discussed above, there are sincere differences in how researchers approach

empirical analyses, routinely leading to mixed evidence relating to many, if not all, social issues. But it can still be worse. What if researcher bias is *insincere*?

Consider the following hypothetical situations:

1. The Recording Industry Association of America funds a study that ultimately finds that sharing music files is detrimental to the music industry.
2. The American Medical Association funds a study that ultimately finds that tort reform to alleviate the burden of medical malpractice liability improves health outcomes for patients.
3. A pro-death penalty group funds a study that ultimately finds that capital punishment reduces the murder rate.

How much confidence do you place in the results of these studies? Would you place more confidence in the results if they were *not* funded by these groups?

At times, empirical researchers are criticized for being influenced by their source of funding. But even without outside funding, researcher bias still has the potential to influence empirical research. If a nonfunded pro-death penalty researcher finds that capital punishment reduces the murder rate, should that result be ignored? If the same researcher finds that capital punishment does not reduce the murder rate, should that result be taken more seriously than if found by another researcher known to be neutral? How important is it to gauge researcher bias, for whatever reasons such bias exists, to determine the integrity of the empirical results?

The difficulty in considering researcher bias is not that it can be a problem, but that it has the potential to *always* be a problem. How can you ever be confident that a researcher is completely unbiased? Certainly, it may be prudent to require researchers to be transparent about their sources of funding if any exist, but what is even more important is for researchers to be transparent about their *data*. The key aspects of enhancing confidence in the results of empirical studies are to allow others to be able to verify the integrity of the data, to replicate results, and to test the robustness of the results to various statistical manipulations. To this end, it is important for researchers to *share* data.

Researchers have always had the opportunity to make their data available to others but, until fairly recently, they were rarely compelled to do so. Currently, given the ease of transmitting large computer files, many academic journals are now requiring researchers to make their data available as a condition of publication. For example, consider this statement

by the editors of the *Journal of Law and Economics*, a leading journal in the field:

It is the policy of the *Journal of Law and Economics* to publish papers only if the data used in the analysis are clearly and precisely documented and are readily available to any researcher for purposes of replication. Authors of accepted papers that contain empirical work, simulations, or experimental work must provide to the *Journal*, prior to publication, the data, programs, and other details of the computations sufficient to permit replication. These will be posted on the *JLE* Web site. The editors should be notified at the time of the submission if the data used in a paper are proprietary or if, for some other reason, the requirements above cannot be met. (*JLE* website.)

While this type of measure can help alleviate the problem of researcher bias, one thing it cannot do is help alleviate the lack of consensus empirical research commonly yields. It is important to note, however, that disagreement over step 2 does little to diminish the value of economic reasoning. There are legitimate and passionate disagreements in how to measure trade-offs, but this simply is an unavoidable consequence of the nature of empirical work. Any academic discipline that attempts to apply empirical analysis to policy issues will have to confront these same problems.

Steps 1 and 2 are typically integral parts of step 3, the policy stage, but the converse is not true. Economic analysis, even of “real world” legal rules, does not have to include an explicit policy component. For example, let’s say you are interested in determining if the death penalty can deter murder. You recognize that there are many costs and benefits to consider when analyzing capital punishment, but you only want to focus on its deterrence benefit. You begin with step 1.

In this case, step 1 is fairly straightforward. You assume that the death penalty is a more severe punishment than the next alternative (life imprisonment, for example), and then you predict that when criminals face an increased cost of their behavior as the severity of punishment increases, they will rationally respond by committing fewer crimes. Thus, your theoretical prediction is that the death penalty will deter murder. Step 2, the empirical verification of the deterrent effect of capital punishment, is a much more complicated process. But after you collect your data, and perform all the relevant statistical procedures, you do indeed find empirical verification that the death penalty deters murder. So now what do you do with this result? That depends on how you approach applying economic analysis to the law—*positively*, or *normatively*.

Positive economic analysis is primarily concerned with trying to explain *what is*, whereas normative analysis tries to argue *what should be*. We observe that only some jurisdictions enforce capital punishment. Can we explain why this is so? We don't have to have any particular interest in the policy aspects of capital punishment to want to identify, measure, and understand its costs and benefits. In addition, positive analysis can be used to examine questions such as *what has been* or *what can be*, again without any policy objectives in mind. Why has tort law relating to product liability dramatically changed over the past century? Can we predict how copyright law will change as copying technology continues to improve in quality and become less expensive?

Part of the confusion between the two approaches to economic analysis is that much positive economics, especially in a field like law and economics, leads to immediate normative implications. But as legal scholar Richard Posner (1979, 286–87) points out:

The use of economics to support legal policy recommendations may seem to raise inescapably the issue of the adequacy of economics as a normative system, but it does not. The economist who demonstrates that criminals respond to incentives and hence commit fewer crimes when penalties are made more severe is not engaged in normative analysis. His demonstration has normative significance only insofar as the people who think normatively about criminal punishment consider its behavioral effects to the design of a just punishment system. In measuring economic costs and benefits, the economist *qua* economist is not engaged in the separate task of telling policymakers how much weight to assign to economic factors.

I do not mean that this separate task is uninteresting or unimportant, but only that it is not part of economics as such . . . So long as it is accepted that the economist can measure costs and that costs are relevant to policy, economics has an important role to play in debates over legal reform.

And this “important role” of economics leads us to our last step.

## **Policy**

Most economic research concerning public policy issues is meant to advise those in the position to implement policy. (In some cases, it is economists

themselves who are in a position to implement policy, such as former chairman of the Federal Reserve Ben Bernanke). While some economists leave it to the audience of their research to determine its policy implications, others embrace the normative aspects of economic analysis and make explicit policy suggestions. The first task in advising public policy is to have a policy objective, and to this end economists typically favor the objective of *social welfare (or social wealth) maximization*.

The specific form of a social welfare function can vary across applications, but it always has one common feature—it posits an objective that is achieved when resources are used efficiently. As for the concept of efficiency, that may entail moving a resource to a higher-valued use (as in property law, discussed in chapter 1) or continued spending to reduce the accident rate as long as there is a return of more than a dollar in safety benefits for each dollar spent on resources used to lower the probability of an accident (as in tort law, chapter 7). Social welfare maximization, then, remains largely unconcerned with notions of fairness. According to some scholars, this is precisely why social welfare should be the guiding objective considered in policy settings:

This article is concerned with the principles that should guide society in its evaluation of legal policy. We consider two fundamental approaches to such normative evaluation, one based on how legal rules affect individuals' welfare and the other grounded in notions of fairness . . . Our central claim is that the welfare-based normative approach should be exclusively employed in evaluating legal rules. That is, legal rules should be selected entirely with respect to their effects on the well-being of individuals in society. This position implies that notions of fairness like corrective justice should receive no independent weight in the assessment of legal rules. (Kaplow and Shavell 2001, 967)

Unsurprisingly, this view has been subject to various degrees of criticism from a number of other legal scholars, with the following excerpt presented as an illustrative example:

The things people want and value are too complicated. What counts as good and bad, fair and unfair, just and unjust, and how much anyone cares about the answers to those questions—the content and extent, in other words, of our taste for fairness and distaste for injustice—are important to people; the answers to those questions are significant aspects of how we define ourselves. So long as this is true, no amount of argument ever is likely to show that debating

those questions and giving weight to the answers perform will make people worse off. (Farnsworth 2002, 2026)

These normative arguments concerning what criteria should govern public policy are important and worthy of serious consideration, but are well beyond the scope of this book. Furthermore, if desired, they can be neatly sidestepped without losing much in terms of understanding the economic approach to law.

It may be tempting to conclude that when you see an economic analysis that uses a social welfare function, it must be a normative analysis. But that is not necessarily the case. The objective of social welfare maximization allows the economist to focus on a well-defined efficiency condition, thus facilitating the positive analysis. Certain tort-liability rules are efficient in the sense that they *minimize the social loss* of accidents (the flip side of maximizing social welfare). This allows for a metric to be used to compare liability rules (chapter 7). What isn't required is a statement justifying the objective because it is what policy makers actually do or should care about. A social welfare function may be nothing more than an analytical tool used to help understand and explain legal rules, even if it can also be used to advise public policy.

In cases where there is broad agreement over the use of social welfare to govern both positive and normative economic analysis, there may be disagreement over precisely what should be counted as social welfare. An excellent example of this can be found in the economic analysis of crime (chapter 10). To deter crime, society must use resources for the apprehension, conviction, and punishment of criminals. These costs are offset by the benefits in crime reduction. But should the benefits that accrue to individuals who commit crime be included in the definition of social welfare? After all, aren't criminals also *part* of society?

In theory, this can be an important issue. If criminal benefits are included in social welfare, this may suggest that fewer resources can be used to deter crime because crime itself has offsetting benefits. It may even imply that certain crimes should be *encouraged* when the benefit to the criminal more than offsets the cost to the victim. Notice, however, that it is a *fact* that a criminal reaps a benefit from committing a crime (or else why commit the crime), yet it is an *opinion* as to whether that benefit should be counted as social welfare. So what opinions do economists hold on this issue?

In his seminal paper, Nobel Laureate Gary Becker (1968) simply took it for granted that a criminal's benefit should be included as a variable in

his model of crime and punishment. This matter-of-fact inclusion caught the attention of another Nobel Laureate, George Stigler (1970, 527):

Becker introduces as a different limitation on punishment the “social value of the gain to offenders” from the offense. The determination of this social value is not explained, and one is entitled to doubt its usefulness as an explanatory concept: what evidence is there that society sets a positive value upon the utility derived from a murder, rape, or arson? In fact, the society has branded the utility derived from such activities as illicit. It may be that in a few offenses some gain to the offender is viewed as a gain to society, but such social gains seem too infrequent, small, and capricious to put an effective limitation upon the size of punishments.

This disagreement between two of the profession’s greatest scholars illustrates the difficulties associated with determining what should be counted as social welfare.

In general, economists tend to be *inclusive* when considering what to count as social welfare, as explained by law and economics scholar David Friedman (2000, 230): “If instead of treating all benefits to everyone equally, we first sort people into the deserving and the undeserving, the just and the unjust, the criminals and the victims, we are simply assuming our conclusions. Benefits to bad people don’t count, so rules against bad people are automatically efficient.” But even an eloquent statement like this one does not change the fact that what counts as social welfare is always a matter of opinion, and that’s assuming you care about the objective of social welfare maximization in the first place.

There is no denying that advising public policy based on economic analysis is challenging to do. Even if most economists agree on the objective of maximizing social welfare, there may still be disagreement as to what that actually entails. And if economists are in precise agreement over the policy objectives, the difficulties associated with empirically measuring trade-offs, as discussed above, may nevertheless still lead to a variety of policy opinions. As economists debate among themselves over appropriate policy measures, things can get more complicated for policy makers looking for advice when scholars from numerous other disciplines weigh in with their views.

The economic approach to law does not have to be thought of as more important, or more correct, than other approaches. Policy makers may find economic reasoning useful in thinking about which policies to enact,

or they may choose to ignore it all together. Throughout this book, many examples will depict law and economic analysis (both positive and normative) as interesting, unique, and at times even a bit unusual. By the end, you will have to decide for yourself whether you find economic analysis to be important. But even if you find it to be unimportant, you will at least come to that conclusion with a better understanding of *why* you find it to be that way. In the highly contentious area of social policy analysis, the more views that are considered, the more rigorous the analyses become both theoretically and empirically, the more information policy makers can draw upon, the more likely the ultimate (and possibly naïve) goal of public policy—to try to improve the world in which we live—can be achieved, regardless of what the words “improve the world” mean to you.

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