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What is Law and Economics Today? A European View

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Index

I. Distinctions and the Common Core 99
II. Law and Economics in Economics 101
III. Law and Economics in the Law Schools: The Case for Cooperation 101
IV. A Divide Between Common and Civil Law? 103
V. Reception Top Down or Bottom Up? 104
VI. The Development of the Literature 105
VII. The Students' Choice 110
VIII. The Example of European Company Law: The Centros Doctrine 110
IX. Law and Economics in the Design of Business Transactions 112

I. Distinctions and the Common Core

Law and Economics may be divided into three related (positive and normative) exercises:

(1) The use of economic methodology for explaining the functions of existing legal rules and legal decision-making;

(2) A joint research effort of lawyers and economists for exploring the preconditions, mechanisms and effects of institutional choice;

(3) An educational program for promoting a productive dialogue between the two dominating social sciences, law and economics, for developing state-of-the-art solutions for complex socio-economic problems.

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EIAN MACKAAY, in his impressive recent account of the “History of Law and Economics” in the Ghent Encyclopedia of Law and Economics, emphasizes:

"[The approach] explicitly considers legal institutions not as given outside the economic system, but as variables within it, and looks at the effects of changing one or the other elements of the system. In the economic analysis of law, legal institutions are treated not as fixed outside the economic system, but belonging to the choices to be explained."

At a Chicago conference on the future of law and economics in 1997 the discussion between Douglas Baird, Gary Becker, Ronald Coase, Richard Posner and Richard Epstein stressed that the original simplicity of the approach may have accounted for the huge success of the movement.

They isolate as the four core notions:
1. people maximize;
2. markets clear;
3. the moves make parties better of (“efficiency”);
4. institutional choice matters.

Every one of these four simple propositions, of course, has a number of qualifications. Using the basic paradigm of assuming hypothetical ex-ante bargains between self-interested individual actors provides substantial insights in the functioning and possible design of legal rules. This is the bottom-line of the first comprehensive application of the theory to an array of core legal subjects published by RICHARD POSNER in 1972. I cannot think of any other book written by a lawyer which has had such an impact on economics as a discipline.

POSNER worked and taught in a law school. In the following I will – without challenging the common core – show that law and economics can be best understood in a Janus-headed appearance: it looks at both disciplines, and makes an impact on both. There is law and economics in economics, and there is law and economics in law.

II. Law and Economics in Economics

Today law and economics is a standard subject of the economic curriculum (whether in the US or elsewhere). There are regular contributions in the top twenty economic journals, written by highly recognized specialists. A substantial number of scholars who have pioneered or refined institutional analysis have received the Nobel Prize in economics; the list would be too long to be quoted in full without further explanation. The relevance for day-to-day policy advice is substantial.

Besides a vast literature on nearly all relevant institutions the main theoretical accomplishments of the last two decades concern a better understanding of information in markets and organizations, the theoretical development of contract and agency theory, and the experimental and theoretical exploration of individual and group decision making by economic psychology, experimental economics and game theory. Here at St. Gallen I should mention that the business schools have also greatly benefited from the rigor of the new institutional analysis. The “economic side” of the economic analysis of law is a huge global success.

III. Law and Economics in the Law Schools: The Case for Cooperation

I have been asked to present a European view on the present status of law and economics – as an academic lawyer who is in the field since the early 70’s – and I will essentially treat the “legal side”.

How did law and economics develop in the law schools? Did it matter for the development of law? What are the achievements and what are the chances of integrating institutional analysis in legal reasoning?

Obviously, I do not intend to convert all lawyers into economists, but I’d rather start from an existing specialization. The emphasis is on a discussion of the necessity of cooperation and communication. We face separate disciplines, not with the claim of autonomy of each, of law and of economics, but in the best

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4 My list of relevant institutionally oriented economists would include laureates like e.g. Kenneth Arrow, Friedrich von Hayek, Herbert Simon, James Buchanan, Ronald Coase, Gary Becker, Douglass North, Reinhard Selten, George Akerlof, Vernon Smith, Daniel Kahnemann, and Thomas Schelling.
IV. A Div' e Between Common and Civil Law?

In Europe there are, of course, differences from country to country, but they are mostly overrated. One example is the overstatement of the gulf between common law countries and civil law countries, which may have been inspired by mixing up the concepts of regulation and codification. In the past the hesitant and sometimes cumbersome reception of law and economics in European countries was attributed to this difference between a judge-made common law and codified civil law. 7 If this factor had been of high significance, we would have seen a quick and effective reception in England and Scotland and, for example, a slow reception in Germany. I share CHRISTIAN KIRCHNER’S proposition that the reception in Germany was, at least at times, difficult.8 But as I will show, it has been “reasonably successful”. Comparing it to the English situation I would say that England has at no point become a real bridgehead for the law and economics reception in Europe.9 The difficult case of France indicates an interesting factor for resistance. It is already stressed in MACKAAY’S account; the centralist decision making of the French educational system. Nobody will become an assistant or a law professor in France without the screening and consent of the Paris bureaucracy.10 However, law and economics is present in France on the “economic side” as is demonstrated by last year’s impressive collection by CLAUDE MÉNARD and colleagues on the new institutional economics.11 Its arrival on the “legal side” is shown by the recent introductory text, “Économie du droit: le cas français”, by ANTHONY OGUS and MICHEL FAURE, 2002, a true entente cordiale.12 The movement has reached Paris, although, to paraphrase COASE, it was not always welcome there.13 The case of France is also an example for the different speed of the reception of law and economics in the law faculties and law and economics in the economic departments and business schools.

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5 The „productive“ process of joining the separate styles of analysis for drafting viable „consti-
tutions“ for economic transactions is elaborated in: ERICH SCHANZE, „Legalism, Economic-

6 The differences and similarity are treated in: ERICH SCHANZE, „Vorlesungskonstellationen in der Ökonomischen Analyse in den USA – Verbindungslinien zur realistischen Tradition“, in: ASSMANN, KIRCHNER, SCHANZE, Ökonomische Analyse des Rechts 1-16 (2nd ed. 1993).

7 See e.g. RICHARD POSNER „What Is Law and Economics Today? An American View“, this volume. It is one of the early, obviously unshakable articles of faith in the Chicago law and economics gospel. The argument seems to overlook that the core principles of civil law codifications are not interest group driven “regulation” in the US meaning but rather restatements of long historical lines of rule making of judicial/jurisprudential origin, however one assesses the “efficiency” of the individual solutions.

8 CHRISTIAN KIRCHNER, „The Difficult Reception of Law and Economics in Germany“ 11 Intl. Rev. Law & Econ. 277-292 (1991); see also „Einleitung zur Neubearbeitung“ in: ASSMANN, KIRCHNER, SCHANZE (above note 6) at IX-XI.

9 At this moment (end of 2005) the interest at Oxford and at the LSE seems to be less than, for example, at Cambridge.

10 See MACKAAY (above note 1) at 84-85.


V. Reception Top Down or Bottom Up?

With a winking eye I should remark at this point that the French and the US cases have, in a way, the common feature of central decision making of the educational system. Both operate— from a German perspective— top down.

Law and economics was initiated at one of the top US research universities, the University of Chicago, and spread, in a relatively short period, to the top ten American law schools, which are responsible for the staffing of the next hundred in a total of more than 300 law schools. The bitter fight at Harvard Law between the factions which I witnessed in my second stay in 1978 (interviewing my former law teachers and colleagues on what they thought of law and economics) was a special case. I assume that, until now, law and economics has not reached the bottom of the highly stratified pyramid of American law schools. The competitive factor for introducing law and economics in the law schools was the daring success of the elite business schools in the 80's and the increasing demand for economic expertise in government and industry. The elite law schools responded on the teaching side with portions of training in economics. However, I do not want to belittle the "fire of truth",14 the sophistication of legal reasoning by using law and economics-thinking, and the impressive relevant research in the law schools.

Consider, in contrast, the German or Swiss situation. Although ranking between the schools has become fashionable, the some fifty law faculties in the Länder or the Kantone are still regarded as almost equal, or at least organized in a very flat hierarchy. Almost every faculty considers itself a research faculty, and trains, in a long process of two doctorates, professorial staff. Proselytes can only be made on a person-by-person, faculty-by-faculty basis, but not by the benign dictatorships of Paris or of the elite US law schools.

A natural point for explaining bars against the diffusion of superior knowledge for a person having worked for a while next door to the office of RONALD COASE is, of course, regulation. In the middle of Europe there are state exams, and a highly regulated legal education. This is, at least in Germany, orientated at the ideal of educating career judges, who interpret the codified law. Likewise, the commentaries on the principal codifications are considered the high mass for the professorial services. France is an exception at this point, because the repertoires or précis are written by the maîtres de conférence, the assistants.

VI. The Development of the Literature

What is law and economics today in Europe in terms of the published literature? For Germany the count for the Ghent encyclopedia (of the late nineties) offers some sixty pages of more than a thousand entries,15 indeed a large amount of literature.

If we define economic analysis of law broadly as a study of institutional phenomena with economic methodology, this would easily double or triple the numbers. If we were to reduce the definition to those books and articles, which imply or result in a direct guidance in the interpretation on making of laws or legal decisions, there may be still more than the listed entries because of the collection bias, but there would be substantially less. Would we include articles written by economists for economists on institutional issues? This is an extremely rich literature which plays today a large role in the qualification and the current work of academic economists. It also relates to the frequent complaint about the increasing formalism of the relevant papers. If I want to qualify as an economist, I have probably to comply with the requirements of the craft, and the craft emphasizes, in my view, largely correctly, models, regressions and advanced algebra. The literature is a logical consequence of a rapid specialization and diversification of the subject. Looking back, the Fels Lectures on The Limits of Organization by KENNETH ARROW,16 the articles and books of BORK,17 BUCHANAN and TULLOCK,18 CHEUNG,19 MANNE,20 NELSON and WINTER,21 NORTH,22 and, of course, of RICHARD POSNER,23 seem to have been written in an age of innocence. This leads to the provocative

23 POSNER, above note 4 and his more than twenty books and hundreds of articles.
question (and possibly an irony): How many papers of the “Journal of Law and Economics” are law and economics papers today?

From the comparative perspective it is interesting that law and economics kept an academic stronghold in the US law schools. In Germany, and in almost all relevant European countries, the important moves were mainly carried out by economists and economics faculties. It was a group of highly respected economists who were running some of the leading textbooks in economics who turned at the end of the seventies, almost in conversion movement, to institutional economics. I should mention the alliance between EIRIK FURUBOTN and RUDOLF RICHTER and the subsequent Wallerfangen Conferences,24 which were academic efforts on a very high level – and it was clear that the economists invited the lawyers. The same could be said about initial Münster conferences organized by ERIK BÖTTCHER and HERDER-DORNEICH.25 Both efforts got immediately published in relatively high ranking periodicals. The old “Zeitschrift für die gesamte Staatswissenschaft”, the oldest economic journal in Europe, was converted into the “Journal of Institutional and Theoretical Economics”. For the few academic lawyers involved in law and economics in the seventies, it was easier to find an intellectual platform in the established economic circles than for economists to enter in the law schools. The academic entrepreneurship of RICHTER or BÖTTCHER was matched a few years later by the economist HANS-BERND SCHÄFER who joined forces with a lawyer, CLAUS OTT, for organizing the Travemünde Conferences and the Erasmus Project at Hamburg.26 In this case the program was located in and sponsored by a reformist law faculty. By closer inspection of the present situation, however, the Hamburg postgraduate program which is offered to both, lawyers and economists, seems to be much more attractive for economists than for lawyers.27

Let me digress on the relation of education, professional training, and writing. The study of law in the US, unlike in most other countries in the world, is a

postgraduate study. The chance for law and economics lies in the fact that top law students in top law schools, have in many cases a solid undergraduate economics education. If I exclude the doubtlessly very important and most relevant cohort of “economic” law and economics scholars in Europe who are straight qualified as economists and turn to the lawyers, there are currently four ways for a lawyer to qualify in law and economics:

1. to obtain a degree in both subjects;
2. to study law and economics in a post-graduate study in a leading US law school;
3. to undertake a doctoral study in the field;
4. to undertake relevant postdoctoral studies (Habilitation).

The five year study at St. Gallen leading to a law degree is indeed an innovation. Until today, law and economics in the academic training in Europe (and I include the economics departments at this point) is largely a postgraduate or postdoctoral affair. Turning to the literature one can say that the “legal” lawyers/economists are mostly publishing books and do not publish in periodicals. In contrast, the “economic” law and economics scholars mostly publish in journals.

The writing of books of the cohort of legal scholars leads – in individual cases – to remarkable achievements which would not enter easily in the picture of the typical law and economics society perception of law and economics literature. In some way they still remind me of CALABRESE’s and POSNER’s early publications.

As law and economics persons we believe in the productive virtue of individualism and competition. There is a wealth of literature which does not come to the attention of an economist, who would send out questionnaires to the faculties on books and articles on law and economics.28 I am not talking about those textbooks, legal dissertations or Habilitationsschriften, which have either “economic analysis” in their title or which have been sponsored at the law faculties by the usual suspects like PETER BEHRENS, CHRISTIAN KIRCHNER, FRIEDRICH KÖBLER, INGO KOLLER, WERNHARD MÖSCHEL, ERICH SCHANZE, or now, the second generation of true believers. There are hundreds of dissertations, typically books of 200-300 pages and some thirty Habilitationsschriften, typically between 300 and 1000 pages containing major chapters on law
and economics, using more or less intensively the relevant international literature.

A substantial percentage is repetitious, illustrating mainly the own learning process of the writer. But that may be true for many law review articles written by young law and economics scholars in the US. The more interesting books are those, where the bright young scholar is in a fight with her or his master—and many minor battles have been fought in the past, sometimes ending at par. Typically she or he will come back from his/her LL.M. year at one of the leading law schools and then write a dissertation as an assistant.

A good example is HORST EIDENMÜLLER’s “Effizienz als Rechtsprinzip” (efficiency as legal principle)\(^2\) written in Munich under the supervision of two prominent professors who had a very clear taste for law as an autonomous discipline. The thoughtful exposition of efficiency as a legal principle ends in a compromise, which the author, now himself a member of the Munich faculty, supervising a good number of law and economics dissertations, would defend today in rearguard action.

Economic analysis, EIDENMÜLLER suggests, is a brilliant tool for designing legal policy in the legislatures. But judges should rather abstain. He would probably argue, which I appreciate, that it is not up to the judges to legislate. But it is also common sense that judges do legislate, and so the distinction is rather artificial.

ANDREAS BLASCHCZOK, a remarkable scholar who died in the age of 47 in 2000 wrote in the early nineties his book on strict liability and allocation of risk\(^3\) at Passau, again under the supervision of an outspoken “autonomist”. I translate the moving lines of thanks to his teacher in the introduction. It is a long German sentence which is hard to translate. “It is impossible to express adequate thanks to my academic teacher. Not only in his own research interest, but also in the interest of my own work, he familiarized himself with the not quite common way of thinking called economic analysis of law, so that I constantly received support and encouragement from him.”\(^4\)

\(^3\) ANDREAS BLASCHCZOK, Gefährdungshaftung und Risikozuweisung (1993).
\(^4\) Idem, Preface at VI [transl. E.S.].

HOLGER FLEISCHER\(^32\) and GREGOR THÜSING,\(^33\) in a similar situation at Cologne, included large parts of law and economics in their books, in the case of FLEISCHER on informational asymmetry in contract law, and in THÜSING’s case on the calculation of damages. Both concede to their masters that law and economics alone does not suffice for resolving legal problems. They state firmly that solutions reached by economic analysis have to be underpinned by considerations of balancing of values.

My enthusiasm for the many white knights fighting for the cause of law and economics in difficult terrain was slightly dampered in one case, which may be also one of many. I met a brilliant assistant of a former colleague of mine, who told me to my surprise: “You will be delighted to hear that I have written a major chapter on the law and economics of information in my Habilitationsschrift. But the manuscript was long enough. I have not submitted that part to the faculty, as you will understand...” This does not mean that he is lost for the flock. If a brilliant young girl or boy will come back from their LL.M.s in the US, this professor will certainly supervise them without resistance and will not urge them to select a topic outside law and economics.

Despite the fact that law and economics does not feature prominently in law teaching,\(^34\) it has become an established research approach – at least in the area I am working in, the law of business transactions such as contracts, corporations, or issues of regulation. Increasingly I see state-of-the-art work in a comparative perspective which would decorate every leading US law review. I am just reviewing an original paper on the remedial aspects of efficient breach which will carry the US discussion further.

\(^32\) HOLGER FLEISCHER, Informationsasymmetrie im Vertragsrecht (2001), especially at 28–70, 93–222.
\(^33\) GREGOR THÜSING, Wartende Schadensberechnung (2001), especially 334–425. See also, e.g., the Habilitationschriften by HERBERT HIRTE, Berufschaftung (1996) and STEPHAN GRUND-MANN, Der Treuhandvertrag (1997), MARTIN HENSSLER, Risiko als Vertragsgegenstand (1994) or REINHARD ELLGER, Bereicherung durch Eingriff (2002). An excellent recent example of a Swiss Habilitationschrift is MARKUS RUPFNER, Die ökonomischen Grundlagen eines Rechts der Publikumsgesellschaft (2000); for Austria see e.g. GEORGE GRAF, Vertrag und Vermau (1997).
\(^34\) A notable exception is the brilliant textbook on torts which can now be regarded as the leading German text on this subject: HEIN KÖTZ and GEBHARD WAGNER, Deliktsrecht (10th ed 2005).
VII. The Students’ Choice

Law and economics has become an attractive intellectual enterprise in Europe. Let me cite a further example concerning a recent block seminar. 0.5% of the German students receive support from the Studienstiftung des Deutschen Volkes, a national foundation for the best students. Senior fellows organize yearly conferences for the junior fellows selecting topics of their choice which are screened in a competition between teams. Instructors are selected nationwide by the students. Last year law and economics was one of the few chosen topics, and a conference was organized in a cloister in Bavaria. It was quickly overbooked. From the papers and presentations it was one of the liveliest events I have experienced in the last years. Students mainly came from law, economics, and a few from the political sciences. In the end, the conference results were critically summarized. Ten years ago I would have expected a fundamental critique of the basic assumptions of economics as a science of social engineering. At Frauenchiemsee the message was: We will make any effort for improving the communication between the subjects; we will study the other field more intensely. To institutionalize this kind of dialogue is exactly the aim of the St. Gallen MLE Program.

VIII. The Example of European Company Law: The Centros Doctrine

Does law and economics reasoning affect legal practice? I will present a single example on the European level which seems to me of high practical significance.

In the Nineties a Danish couple wanted to register an English Limited established for the purpose of trading with wines and spirits in Denmark. The registration asked for compliance with the Danish requirements of minimum capitalization. The European Court of Justice in 1999 considered this as an impediment against the freedom of establishment and argued that creditor protection may be achieved by contractual means and by the harmonization publicity requirements of the European directives. The same reasoning was applied in a case in which the German courts did not recognize a Dutch company operating in Germany. Finally, in 2003, a plenary decision by the court concerning a Dutch legislation against so-called pseudo-foreign corporations consolidated this line of reasoning. The rationale in Centros and the other cases is almost a textbook application of POSNER’s original text on corporate law:

“Limited Liability is a means not of eliminating the risks of entrepreneurial failure, but of shifting them from individual investors to the voluntary and involuntary creditors of the corporation – it is they who bear the risk of corporate default. Creditors must be paid to bear this risk... It has been argued that limited liability enables a business to externalize the risk of failure. The voluntary lender, however, is fully compensated for the risk of default by a higher interest rate that the corporation must pay the lenders by virtue of its limited liability...”

The decision line of the European Court of Justice has the salutary effect that the corporate law jurisdictions will have to compete for entrepreneurs in Europe. The option alone has induced national legislators to clean up the company laws and to offer less onerous conditions for incorporation. One should mention at this point that institutional competition does not fully match the concept of competition between sellers of goods. My principal explanation of the institutional choice, for example of Delaware, is neither racing to the bottom nor to the top, but rather the selection of the most standardized regime including its qualified service industry in bench and bar.

Not all European policies for creating access to a single market are, to be sure, inspired by law and economics reasoning. The harmonization in the consumer and labor markets has, despite its effect of opening up the relevant markets, clear disadvantages of overregulation, paternalism, and in part rent-seeking of...
the specific clientele. The deregulation in the field of company law corresponds with the establishment of a regulatory thicket if not a jungle in some fields of capital market regulation, which does not seem to be inspired by efforts for facilitating transactions on these markets, but rather to attract business for consultants.

But there are indications that law and economics reasoning has had a pervasive impact on the style of legislation in the last twenty years. A brilliant example is the increasing use of sunset laws, moreover, the increasing consciousness that there should be serious prior guesses about the cost of a specific regulation. The discussions about competition law and takeover law have largely been structured in law and economics terms. The technology of environmental regulation cannot be understood without recourse to the principles of economic analysis of the institutional choices. The work of the Joint UK Law Commissions concerning company law reform was heavily inspired by advice in terms of law and economics.\(^4\)

IX. Law and Economics in the Design of Business Transactions

The most important, but also most discreet phenomenon of global progress of law and economics is – in my view – achieved in the area of structuring complex business transactions. Examples: The structuring of new products in the security markets, the innovative arrangements in the supply and marketing chains including dedicated internet platforms, the organization of industrial projects and of knowledge systems, the logistics of international transport, servicing, accounting and debt clearing.\(^5\)

Some of my colleagues point out that they can teach contract and corporation law without much reference to economics. They would probably concede that the new arrangements are outwith their reach. The advanced arrangements which I have in mind, can only be developed, maintained, and in the end – if at all necessary – adjudicated if a "synthetic approach" between the two professions of lawyers and economists is observed.\(^6\) May I remind you that the breakdown of one of the most respectable European trading houses was caused by a misunderstanding of an extremely complex long-term hedging strategy? In the case happening in 1994 neither the management could fully explain what they had done nor did the relevant financing banks understand the scheme.

On the whole, the theory of incentive compatible contracts is a most useful analytical tool, but it is useless without a deep involvement in the practice of transacting, and that is still the domain of lawyers. In the area of institutional design both lawyers and economists have to develop a strong capability of speedy and easy transfer of knowledge, which requires a solid understanding of the specialized knowledge systems in law and in economics.

Obviously, I am not pleading for lawyers, who spend their evenings by studying the latest articles in the top twenty economic journals. Nor do I require from a young economist to study all details of a specific area of the law, possibly including the necessary comparative aspects. I believe in specialization, but I also believe in interface capability.

Initially I referred to a joint academic effort for explaining the preconditions, mechanisms and effects of institutional choice. But I also emphasized that the academic effort has to be matched by an educational program promoting a dialogue between lawyers and economists.

The elite law schools in the US have pioneered this project. We have every reason to believe that a prominent European research university like St. Gallen will also be successful with its new program.

I started my lecture by calling law and economics a Janus-Headed approach. Janus is a double-faced Roman god of great significance. He protects the public doors and passages.\(^7\) Law and economics provides the necessary doors and passages for tackling complex socio-economic problems. This is my view of law and economics, how it ought to be, from a European perspective.


\(^6\) See Schanz, above note 5.

\(^7\) Janus", in: Der Kleine Pauly – Lexikon der Antike vol. 3, 1311-1314 (1975).