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New Frontiers of Law and Economics

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Being an economist myself and having occasionally touched upon the field of law and economics in my own teaching and research, I am of course well aware of the impressive career of law and economics as a field in institutional economics. What has always puzzled me, however, was my irritating observation, that it was not the economists trained in the economic discipline of law and economics who wrote new laws on the economy, acted as judges on corporate affairs or wrote contracts.

It is therefore better to turn to the future lawyers and judges for sharing with them management and economic insights, instead of offering Law and Economics courses to economists. I was therefore very pleased that the Law and Economics initiative at the University of St. Gallen set out to do just this.

We have an interesting conference ahead of us. What is Law and Economics today? What are the current research topics in Law and Economics? What are the practical implications of Law and Economics research? Eminent speakers will share their views with us and we will have ample opportunity to hold discussions with them. Let me take the opportunity to thank all of them.

What is Law and Economics Today? An American View

Richard A. Posner[*]

I have been asked to discuss the law and economics movement from an American standpoint. There is indeed a distinctively American approach to law and economics; there is also a distinctively Continental approach, which I will glance at later by way of contrast.

I will discuss the roots and the development of the American approach; what it is today; and what the future holds for it.

The earliest harbinger of the approach was JEREMY BENTHAM's analysis of criminal punishment.[1] He used the language of what would today be called utility maximization, but, terminology aside, his was a highly competent, remarkably prescient economic analysis of an important area of legal regulation, notably of nonmarket regulation.

His innovation lay fallow for a great many years. By the end of the 1950s, it is true, there was a thriving economics of antitrust law and of public utility and common carrier regulation, and a nascent economic analysis of taxation and of corporate law. But economic analysis of law could not really "take off" until BENTHAM'S discovery that economic analysis could be applied to human behavior outside of explicit economic markets was rediscovered. It was rediscovered (I believe independently – that is, I do not think BENTHAM was the actual inspiration) in the 1960s primarily by RONALD COASE,[2] GUIDO CALABRESI,[3] and GARY BECKER,[4] the former two writing about tort law and

* Judge, U.S. Court of Appeals for the Seventh Circuit; Senior Lecturer, University of Chicago Law School. This is the revised text of a lecture given at the First International Scientific Conference on Law and Economics at the University of St. Gallen: New Frontiers of Law and Economics, October 28, 2005. I thank MEGHAN MALONEY for research assistance.

1 JEREMY BENTHAM, An Introduction to the Principles of Morals and Legislation (1789).

2 R. H. COASE, "The Problem of Social Cost," 3 Journal of Law and Economics 1 (1960 [but actually published in 1961]).

3 GUIDO CALABRESI, "Some Thoughts on Risk Distribution and the Law of Torts," 70 Yale Law Journal 499 (1961).

4 GARY S. BECKER, "Crime and Punishment: An Economic Approach," 76 Journal of Political Economy 169 (1968), reprinted in: The Essence of Becker 463 (RAMÓN FEBRERO and PEDRO S. SCHWARTZ eds. 1995).

the third about criminal law (really criminal behavior and punishment, rather than the doctrines and procedures of the criminal law).

This was a break with tradition. Traditionally, economics had been thought to be defined by its subject rather than by its method. Its subject was the economy; and the legal system, though understood to affect the economy, was not thought to be itself an economic system, in the sense of a site of activity that could profitably be studied in economic terms. (Climate affects the economy, but the climate is not an economic system.) As a result, with the startling exception of BENTHAM's utilitarian analysis of criminal punishment, there was little economic writing on law outside those areas, mainly antitrust, where the law seemed to have explicitly incorporated economic concepts, such as, in the case of antitrust, monopoly and competition. A more sustained, extensive engagement of economics with law had to await recognition (which again had been anticipated by BENTHAM) that economics is a theory as well as an "area study" – specifically the theory of rational choice, a theory that can in principle be applied to any social activity (even nonhuman), thus including law, even when law regulates nonmarket activities, such as crime, adjudication, or marriage.

The leading economist in refashioning economic theory as the theory of rational choice and in using this refashioning to extend the application of economics to nonmarket activity has been BECKER, who began publishing in the 1950s. His 1957 book on the economics of racial discrimination,[5] and his 1968 article on the economics of crime and its punishment,[6] were landmarks in the emergence of economic analysis of (all) law, though an even greater landmark was RONALD COASE's 1961 article on social cost.[7] In the 1970s and 1980s, the topics in law that were taken in hand by economic analysis were greatly multiplied, a process that has continued into the new century. Today, there is virtually no field of law, or significant institutional dimension of law, that has not been subjected to economic analysis.[8]

It is important, especially for a Continental audience, to note that the focus of the American approach (though in deference to BENTHAM and COASE it should really be called the "Anglo-American" approach) to economic analysis of law is on case law. This is true even though the domain of the common law has shrunk. "Common law" and "case law" must not be confused. Common

5 GARY S. BECKER, The Economics of Discrimination (1957). A second edition was published in 1971.

6 Note 5 above.

7 Note 3 above.

8 See RICHARD A. POSNER, Economic Analysis of Law (6th ed. 2005).

law refers to areas of law such as torts and contracts in which the principal doctrines are created by judges; statutes are incidental. Case law refers to the judicial creation of doctrines not limited to those of the common law, but encompassing doctrines created by judges in the course of deciding cases that arise under statutes and the Constitution; in other words, interpretive doctrines that fill out and elaborate the bare statutory or constitutional text. The reign of case law in the American legal system has not been ended or indeed much affected by the expansion of statutory law, and indeed has been amplified by the extraordinary aggressiveness of the U.S. Supreme Court in interpreting the Constitution. Not only is constitutional law primarily case law, but much of statutory law in fields as diverse as antitrust law, intellectual property law, labor law, pension law, and securities law has been decisively shaped by judicial decisions. In the legal system of the United States, statutes and constitutions are refracted through judicial decisions; often after many years of case development, the meaning of a statute or (especially) a constitutional provision will be far removed from the literal meaning of its text.

Let me give a few examples of specific legal doctrines that have been brought under the lens of economics. First is the standard for adjudging liability in accident cases.[9] The basic standard is negligence, which the cases usually define as a failure to exercise reasonable care. Economics can give meaning to "reasonable care." An accident will impose on the victim a cost, which let me denote by C_a, with some probability (if no precaution is taken) of p; the expected cost of the accident – the cost if it occurs adjusted for the likelihood that it will occur – is pC_a. To prevent the accident will be costly too; let me denote that cost by C_{pr}. If the cost of prevention is less than the expected accident cost, we want the precaution to be taken; and if potential injurers fail to do so, we adjudge them negligent. Hence the test of negligence is $C_{pr} < pC_a$. And studies find that this is a reasonable approximation to how courts do decide whether a defendant is negligent.

For an example of a doctrine based on interpretation of statutory law, I turn to the "fair use" doctrine of copyright law. Copyright law forbids the unauthorized copying of copyrighted works. But does this mean that a book reviewer who quotes brief passages from the book that he is reviewing is an infringer? Literally, yes, but the courts early on interpreted the copyright statute as permitting unauthorized copying in certain circumstances, such as the book review or other settings in which only brief passages are quoted, in the name of

9 See, for example, id. at 167-170.

fair use.[10] The economic interpretation is that the costs of transacting with the copyright owner would be disproportionate to any negative effect on the owner's earnings from his copyright when only brief passages are quoted, since brief passages are not a substitute for the entire book or other work from which they are quoted. Nor would reviewers and other authors be willing to pay a substantial price for permission to quote. So, far from eroding the copyright owner's earnings, book reviews and other works that quote brief passages from the copyrighted work tend on average to increase the demand for the work by conveying information about it to potential buyers. Copyright owners as a class would therefore be worse off if, because quotation of brief passages required their explicit permission, such quotation became rare because of the transaction costs involved in seeking that permission.

Economics has also proved fruitful in explicating features of the procedural and institutional framework of the law, including the decision to settle a case rather than go to trial, the allocation of resources by prosecutors, and the rules of evidence. Consider only the first of these examples. It might seem that since settlement is less costly than trial, all cases would settle. This would be true if the parties to a litigation also agreed on what would happen if the case went to trial. But often they disagree because of legal or factual uncertainty (or both). Suppose that the plaintiff thinks he has a 70 percent chance of winning $1 million if the case is tried, and that a trial would cost him $200,000 more than settling the case would. Then his expected gain from trial is $500,000 ($1 million × .7 – $.2 million), and so he will not settle the case for less than that amount. Suppose that the defendant thinks *he* has an 80 percent chance of winning (and going to trial will cost him the same amount as it will cost the plaintiff); then he will not settle the case for more than $400,000 (the expected cost to him if he goes to trial is $200,000 – 20 percent of $ 1 million, since remember that he thinks he has an 80 percent chance of defeating the plaintiff's claim – plus the $200,000 incremental cost of trial). Since the plaintiff will not settle the case for a price that the defendant is willing to pay (the defendant's maximum settlement price, $400,000, is below the plaintiff's minimum settlement price, $500,000), the case will be tried.[11]

These examples could be extended indefinitely. What they show is, first, a considerable isomorphism between law and economics. That is, law and economics have a parallel structure, both being concerned with the allocation of scarce resources, though they utilize a quite different vocabulary and often different tools. For example, the criminal law "prices" criminal behavior, but it does so in forms (fines and, more dramatically, imprisonment and even execution) that are different from market prices.

[10] WILLIAM M. LANDES and RICHARD A. POSNER, The Economic Structure of Intellectual Property Law 115, 117, 417 (2003).

[11] See POSNER, note 9 above, at 567-571.

Economic analysts of law believe that students of the legal system have been deceived by the moralistic language of the law. The economic analysts believe that that language can be translated without substantial loss of meaning into an economic vocabulary. Indeed many of them believe that much of Anglo-American common law is efficient in the sense that it tries to bring about the same or roughly the same allocation of resources that the economic market would bring about if voluntary transactions were feasible. The negligence formula and the fair-use doctrine are examples of this point. More broadly, economic analysts have shown why strict liability is sometimes more efficient than negligence liability, why liability for breach of contract is strict, and when and why it is efficient to supplement tort rules and remedies with the rules and remedies of criminal law.[12]

Case law and common law are, as I have noted, not identical. Because statutes and even constitutional provisions are often the product of interest-group pressures (there is a rich economic analysis of interest-group politics), one cannot expect statutory and constitutional law to be as efficient as common law, which is less subject to interest-group pressures because of the different institutional character of courts from that of legislatures, unless the judges, in deciding statutory and constitutional cases, completely ignore the legislative policy.

Since the economic analyst studies the law as a system of resource allocation rather than as an expression of moral principles, he or she is naturally very interested in the actual consequences of the law for behavior. The doctrines of the common law may make economic sense, but it does not follow automatically that in application they bring about efficient results. The empirical study of the legal system is difficult, but there is a growing literature that utilizes the distinctive empirical methods of economics to identify the "real world" effects of legal doctrines, procedures, and institutions.[13]

[12] See id., chs. 4, 6, 7.

[13] See, for example, DAVID BJERK, "Making the Crime Fit the Penalty: The Role of Prosecutorial Discretion under Mandatory Minimum Sentencing," 48 Journal of Law and Economics 591 (2005); YAIR LISTOKIN, "The Empirical Case for Specific Performance: Evidence from the IBP-Tyson Litigation," 2 Journal of Empirical Legal Studies 469 (2005); RAYMOND A. ATKINS and PAUL H. RUBIN, "Effects of Criminal Procedure on Crime Rates: Mapping Out the Consequences of the Exclusionary Rule," 46 Journal of Law and Economics 157 (2003).

There are two other important dimensions to American-style economic analysis of law. One is the normative. It is clearly not the case that all legal doctrines, procedures, etc. are efficient. Those economic analysts of law who believe, naturally enough, that efficiency is an important social value will therefore be inclined to recommend reforms designed to make the law more efficient than it is. And so there is a large literature of normative economic analysis of law. It has been influential in the deregulation movement in the United States and in the reform of antitrust law by the courts to bring the law into harmony with the economics of competition and monopoly.

Second, economic analysis has proved to be an important teaching tool. The reason has to do with the extreme surface complexity of the law. The law is divided into numerous fields, each of which has a complex structure of rules. The fields are traditionally studied more or less in isolation from each other; and within each field, the rules tend also to be studied as separate, often self-enclosed bodies of thought. The economic conception of law is much simpler. A relative handful of economic doctrines – such as decision under uncertainty (illustrated by both the negligence standard and the decision whether to settle or go to trial), transaction costs (as in the fair-use example), cost-benefit analysis, risk aversion, and positive and negative externalities – can by repeated application across fields of law and legal rules describe a great deal of the legal system. This enables the student to develop a more coherent sense of the legal system – to grasp the relation of its parts and understand its essential unity.

Let me pause here to contrast the Continental school of economic analysis of law with the American or Anglo-American school. For it is a great mistake to think that economic analysis of law is confined to the Anglo-American sphere. The appearance of this comes from the fact that, paradoxically, the Continental school limits – in the name of economics – the use of economics by judges. The Continental tradition in economic thinking about law, nascent in ARISTOTLE's theory of corrective justice but fully developed in the writings of MAX WEBER and FRIEDRICH HAYEK, emphasizes the importance of law as a *neutral* framework for private conduct.[14] The essence of corrective justice is that the judge is not to take account of the individual characteristics, the merits and demerits, the social standing, the deserts, etc. of the litigants; he is to judge the case, not the parties. MAX WEBER insisted in like vein that the judge's concern is with *formal* rationality – that is, with providing a framework that facilitates private ordering rather than one that prescribes the terms on which

[14] I discuss the Continental school of economic analysis of law in my monograph Law, Economics, and Democracy: Three Lectures in Greece 29 (University of Athens Department of History and Philosophy of Science 2002).

people deal with each other. And so with HAYEK's insistence that judges should enforce customs, which is to say norms created by individuals from the bottom up, rather than laying down rules of conduct invented by the judges on the basis of their conception of sound policy, that is, imposed from the top down.

The Continental tradition assigns a narrow though important role to judges, a role reflected in the emphasis that the Continental legal systems place on detailed legislative codes as the principal source of law, rather than case law; an emphasis that deprives judges of the significant policymaking role that they enjoy in a system of case law and classifies them as part of a career civil service.

I want to close by considering where we are going in the American approach to economic analysis of law – what is the unfinished business?

1. The comparative study of legal institutions. To study the effects of a social institution empirically, using econometric methods such as multiple regression, it is helpful to have a lot of variation; and there is much more variation in legal institutions when one is comparing nations than when one is comparing states within the United States. The legal systems of all our states, with the partial exception of Louisiana, are based on the common law; the legal systems of most other nations are based on the Continental model. The two models, as we know, differ in doctrines, procedures, legal professions, and judicial careers and structures. There is even more variation across systems when the nations compared include the nations of the developing world, most of which have very inadequate legal institutions.[15]

2. Situating law in the total system of social control, which includes custom (much emphasized by HAYEK, as I have noted, and, earlier, by theorists of the English common law), morality, reputation, and emotion.

3. Explaining the behavior of judges. These central actors in the legal systems especially of common law jurisdictions are surrounded by constraints that seem designed to strip them of all the incentives on which the model of rational choice is based. The judicial career is carefully constructed to deny the judge any benefit (or cost) from deciding a case one way or the other, or, indeed, from exerting himself. Not only are judicial salaries fixed, with no bonu-

[15] For exemplary economic studies of comparative law, see "Special Issue on Comparative Law," 7 American Law and Economics Review 1 (2005); EDWARD L. GLAESER and ANDREI SHLEIFER, "Legal Origins," 117 Quarterly Journal of Economics 1193 (2002); RAFAEL LA PORTA et al., "What Works in Securities Laws?" (forthcoming, Journal of Finance, Feb. 2006).

ses or reductions based on performance, but, in many judicial systems, including the U.S. federal judiciary, judges have lifetime tenure and can be removed for only the grossest misconduct. Yet judicial decisions, including those of federal judges, do not appear to be random, or judges strikingly lazy. So what is their motivational structure?[16]

4. Economic analysis of law does not have such intrinsic fascination that it can flourish in an academic hothouse, with no real-world applications. It is not like archeology, which flourishes as a field because of a disinterested fascination with ancient civilization. The continued vitality of economic analysis of law depends on its being able to contribute to the improvement of law. The opportunities are notable in developing countries because their economic problems are bound up with the inefficiency of their legal institutions; the challenge is to reform those institutions piecemeal in the absence of the kind of political and economic infrastructure that supports the legal institutions of the wealthy countries. There are numerous opportunities for economics-guided reform of our own laws and legal institutions as well. But to be feasible, proposals for reform have to be anchored in exact knowledge of the character, structure, and consequences of the existing laws and institutions. A knowledge of the economics of stylized legal rules is not good enough.

5. And closely related: in this task of feasible reform, the literature, as yet neglected by economic analysts of law, in organizational economics has an important role to play. What distinguishes that field is that its practitioners are not content to study stylized models of organization (for example, the "M-form" versus the "U-form"). They study, often in the course of consulting for, actual organizations. So far, it is mainly conventional business firms that are being studied, but the principles of organizational economics are equally applicable to nonmarket organizations.[17] Judiciaries and law firms illustrate the centrality of organization to the legal system. They have received little systematic attention from economists. Such striking developments as the sudden, enormous surge in litigation that began (in the United States) at the end of the 1950s, the essentially effortless way in which that expansion was accommodated by a judicial system already described as overburdened, and the vast recent increase in the size and geographical scope of law firms, are puzzling phenomena that organizational economics may illuminate. It may also help to explain the causes and consequences of the striking organizational differences between the Continental judiciaries, strongly centralized and hierarchic ("U-form") and the U.S. judiciaries, which are much more loosely coordinated ("M-form"). Organizational economics also has much to contribute to unraveling the mystery of judicial motivation. For organizational economists are mindful of the limited feasibility of performance measures even in business firms and the resulting need to establish incentive systems that are not based on efforts to determine a worker's marginal product – systems that may not rely on direct economic incentives at all.

[16] See, for example, ERIC HELLAND and JONATHAN KLICK, "The Effect of Judicial Expedience on Attorney Fees in Class Actions (Claremont-McKenna College Department of Economics and Florida State University Law School, Dec. 1, 2005); RICHARD A. POSNER, "What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)," 3 Supreme Court Economic Review 1 (1993).

[17] See, for example, LUIS GARICANO and RICHARD A. POSNER, "Intelligence Failures: An Organizational Economics Perspective," Journal of Economic Perspectives, Fall 2005, p. 151.

What is Law and Economics Today? A European View

*Erich Schanze**

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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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EJAN MACKAAY, in his impressive recent account of the "History of Law and Economics" in the Ghent Encyclopedia of Law and Economics emphasizes:[1]

„[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[2] 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.[3] 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.

1 EJAN MACKAAY, "History of Law and Economics", in: Encyclopedia of Law and Economics vol. I (Bouckaert and de Gheest, eds.) 65 (2000).

2 DOUGLAS G. BAIRD, „The Future of Law and Economics: Looking Forward: Introduction" (with contributions of RICHARD EPSTEIN, GARY BECKER, RONALD COASE, MERTON MILLER, RICHARD POSNER) 64 U. Chi.L.Rev.1129-1165 (1997).

3 RICHARD A. POSNER, Economic Analysis of Law 1972 (5th ed. 2005).

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.[4] 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

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.

economic sense of joint *value creation* of professional specialization and interaction, and the need for *ambassadorial services*.[5]

There is a sort of Darwinian reality of *specificity*: of the immediate subjects, their problems, the associated working environment, the routines, training, and professional history (which has always played an important part in the self-esteem of the professions). It is fortunate, in my view, that Richard Posner and Jean Tirole have different views of the world and have a command of a different scientific language and methodology. The advantage of law and economics is that Posner and Tirole can communicate with each other.

My assessment will be, no doubt, eclectic, personal, and controversial. I start from the premise that, like on the "economic side", law and economics today in the law schools is neither an American nor a European enterprise. It is, indeed, an international approach.

There are, for example, European journals, a European Law and Economics Society, a successful European network of various law and business faculties within the Erasmus/Socrates scheme, including an impressive doctoral program. But they are working largely with the same literature and within the paradigm found at the US law schools. A postdoctoral researcher from Madrid, who works in 2005 for a few months on issues of corporate governance at Marburg, may in the next weeks travel to Cambridge, England, and from there to Columbia or Harvard. She would not spend time on quarrels concerning the theoretical approach. The concern would be the regulatory context and different basic legal concepts, maybe quirks about the sense or nonsense of the concept of shareholder primacy. I should like to remind that in the past there have been substantial methodological divides between Europe and the US. Think, for example, of the American Legal Realism on one side, and German "Interessenjurisprudenz" on the other.[6]

[5] The „productive" process of joining the separate styles of analysis for drafting viable "constitutions" for economic transactions is elaborated in: ERICH SCHANZE, "Legalism, Economism, and Professional Attitudes Toward Institutional Design," 149 JITE 122-140 (1993) and, id., "Hare and Hedgehog Revisited: The Regulation of Markets That Have Escaped Regulated Markets," 151 JITE 162-176 (1995).

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

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, "Economie 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.

[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.

[11] International Library of Law and Economics (MÉNARD ed.) 7 vols. (2004).

[12] ANTHONY OGUS et MICHEL FAURE, Économie du droit: le cas français (2002).

[13] R.H. COASE, „Economics and Contiguous Disciplines", 7 J. Legal Studies 201 at 207 (1978).

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 dictatorship 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 conference, the assistants.

[14] See EDMUND W. KITCH (ed.), "The Fire of Truth: A Remembrance of Law and Economics at Chicago 1932-1970", 26 J. Law & Econ.163-234 (1983).

It is the regu[illegible]tory advantage of Switzerland and particularly the Kanton of St. Gallen that a combination of a study of law and economics in five years is possible, a fact, which we celebrate with the new MLE program.

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

[15] ROLAND KIRSTEIN, „Law and Economics in Germany", in: Encyclopedia of Law and Economics vol. I (above note 2) 160-227.
[16] KENNETH J. ARROW, The Limits of Organization (1974).
[17] ROBERT H. BORK, The Antitrust Paradox (1978).
[18] JAMES BUCHANAN and GORDON TULLOCK, The Calculus of Consent (1962).
[19] STEVEN CHEUNG, The Theory of Share Tenancy (1969).
[20] HENRY G. MANNE, „Mergers and the Market for Corporate Control", 73 J. Political Econ. 110-120 (1965).
[21] RICHARD R. NELSON and S.G. WINTER, An Evolutionary Theory of Economic Change (1982).
[22] DOUGLASS NORTH, Structure and Change in Economic History (1981).
[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

[24] Published typically in the March issues of JITE, since 1984, see the interesting introductory text by EIRIK G. FURUBOTN and RUDOLF RICHTER, "The New Institutional Economics – Editorial Preface" 140 JITE 1-6 (1984), and the list of participants at p. 231, including, among others, ARMEN ALCHIAN, RONALD COASE, HENRY MANNE, WILLIAM MECKLING, and DOUGLASS NORTH. See also the influential textbook: RUDOLF RICHTER and EIRIK FURUBOTN, Institutions and Economic Theory (2nd ed. 2005) / German title: Neue Institutionenökonomik (3rd ed. 2003).

[25] Published in Jahrbuch für Neue Politische Ökonomie.

[26] See the sizeable textbook: HANS-BERND SCHÄFER and CLAUS OTT, Lehrbuch der Ökonomischen Analyse des Zivilrechts (1986, 4th ed. 2005). The conference transactions were published in individual books.

[27] The fellowships are at the moment (2005), to a large percentage, awarded to fellows with a first degree in economics.

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 CALABRESI'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 KÜBLER, 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

[28] As in the case of the collection by KIRSTEIN for the Encyclopedia (above note 5).

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)[29] 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[30] 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."[31]

29 HORST EIDENMÜLLER, Effizienz als Rechtsprinzip (1995, 2nd ed 1998).
30 ANDREAS BLASCHCZOK, Gefährdungshaftung und Risikozuweisung (1993).
31 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 dampened 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, 93-232.
33 GREGOR THÜSING, Wertende Schadensberechnung (2001), especially 334-425. See also, e.g., the Habilitationsschriften by HERIBERT HIRTE, Berufshaftung (1996) and STEFAN GRUNDMANN, Der Treuhandvertrag (1997), MARTIN HENSSLER, Risiko als Vertragsgegenstand (1994) or REINHARD ELLGER, Bereicherung durch Eingriff (2002). An excellent recent example of a Swiss Habilitationsschrift is MARKUS RUFFNER, Die ökonomischen Grundlagen eines Rechts der Publikumsgesellschaft (2000); for Austria see e.g. GEORG GRAF, Vertrag und Vernunft (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 GERHARD 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.[35] 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?[36] 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.[37] The registry 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 harmonized 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.[38] The rationale in Centros and the other cases is almost a textbook application of POSNER's original text on corporate law[39]:

"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.[40]

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

[35] Studienstiftung des Deutschen Volkes, Konferenz „Recht und Ökonomie", Frauenchiemsee, May 19-21, 2004.

[36] The economist HANS-BERND SCHÄFER remarked in his presentation at this conference that the impact of law and economics on court decisions in Germany is negligible. The question is whether the explicit formal use of economic theory in decisions (which is also rare in the US) is a necessary sign of the theoretical reception. I would argue against a shorthand reception of economic jargon and amateurism in legal decisions. Stylistic consistency in written justifications of legal decisions is an important element of legal certainty and of a rational legal discourse. In this sense I share some of EIDENMÜLLER's caveats against the "use" of law and economics in judicial reasoning (see above note 29 and related text). However, there is no doubt about the power of solid economic reasoning in the pleadings; and one could cite many examples where the judicial decisions reflect economic arguments.

[37] Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen [1999] ECR I-1459; on this case and the following: ERICH SCHANZE, The recognition principle – Tracing Sir Thomas' vision to present European law, in: CAREY MILLER and REID (eds.), A Mixed Legal System in Transition, 293-301 (2005).

[38] Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd. [2003] ECR I-10155.

[39] POSNER (note 4), 1st edition at 174-179; 2nd edition at 292-296.

[40] See ERICH SCHANZE, „International Standards – Functions and Links to Law," in: International Standards and the Law (P. NOBEL ed.) 83-103, at 89 (2005).

the specific clienteles. 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.[41]

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.[42]

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.[43] May I remind you that the breakdown of one of the most respectable European trading houses was caused

[41] For example: SIMON DEAKIN and A. HUGHES, Directors' duties: empirical findings, Report to the Law Commission (1999).

[42] See e.g. ERICH SCHANZE „Symbiotic Arrangements", in: The New Palgrave for Economics and the Law, vol 3 (P. NEWMAN ed.) 554-559 (1998).

[43] See SCHANZE, above note 5.

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.[44] 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.

[44] „Janus", in: Der Kleine Pauly – Lexikon der Antike vol. 3, 1311-1314 (1975).