

EXPLORING THE INTERACTION BETWEEN LAW AND ECONOMICS:

THE LIMITS OF FORMALISM

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INTRODUCTION

As lawyers concerned with the regulation of economic activity, we applaud the recognition in Professor Charles Goodhart's recent Chorley lecture that much of the 'law and economics' of the past quarter-century has involved 'too much one-way traffic'.¹ If law and economics has indeed largely, as Professor Goodhart suggests, consisted of a process of intellectual imperialism, specifically of the colonisation of law by economics, we consider it important to reflect on the reasons for this, and to make some suggestions to improve the collaboration between the two disciplines. In brief, we suggest that this interaction has been bedevilled by its tendency to reproduce the worst aspects of formalism in each discipline.

Professor Goodhart shows that the bulk of law and economics has consisted of a fairly unthinking application of standard neo-classical economic assumptions to legal phenomena which have themselves typically been conceived in conventional doctrinal terms. As with much inter-disciplinary collaboration, the major problem is that it is difficult enough to transcend the limitations of traditional approaches in one discipline, let alone two, yet this is precisely what is needed for that collaboration to realise its full potential. Nevertheless, that law and economics has been dominated by two mutually reinforcing formalisms is to a considerable extent curious, since the emergence of the inter-disciplinary field of law and economics is itself one product of a wider re-evaluation of the traditional epistemological foundations which has taken place in both disciplines. We will suggest that a more fruitful collaboration between law and economics can be developed by taking more seriously the results of these re-evaluations, drawing on the considerable progress that has been made in recent years.

We will argue that further progress in law and economics depends not on reversing the flow of the one-way traffic but (to abandon metaphor) on understanding the social interaction of economics and law. Lawyers and economists operate at the interface between the public sphere of the state and the private sphere of markets, since it is money and the law which act as the key mediating mechanisms between those spheres. The growth of law and economics over the past quarter-century is not surprising, since this has been a period in which there has been considerable debate and conflict about the role and forms both of state action in relation to economic activity and of economic institutions themselves, especially the large firm which has been recognised as playing the dominant part in the markets which structure economic activity. Indeed, the central concerns of law and economics, the firm, the state and the market and the nature of their interaction, lie at the heart of much of public policy. Thus, although some of the intellectual history of this field may seem arcane, it has been of substantial

¹ C.A.E. Goodhart, 'Economics and the Law: Too Much One Way Traffic?' (1997) 60 *Modern Law Review* 1. Unattributed references in parentheses in the text are references to this paper.

consequence in reflecting and underpinning political changes and debates of the greatest importance.

A detailed evaluation of that intellectual history is beyond the scope of this paper.² However, we consider it important to focus on what we argue to be a key aspect of that history, which, although now coming to be widely acknowledged, is still insufficiently appreciated. This aspect is the very questionable nature of the way in which the work of Ronald Coase has been taken up by those who claim to be his followers, especially Richard Posner. We wish to emphasise the importance of Coase's stress on the legal setting of economic activity, but also to suggest that it is necessary to go further than he did in transcending the limitations of formalist views of both economics and law. Formalism consists in analysing one sphere or aspect of social relations abstracted from its broader social context, and then taking that part for the whole; and applying analyses based on such abstractions to all aspects of human activity and social life, without regard to the social context within which they have some validity. Thus, legal formalism views state law as a system of fixed and determinable rules, and assumes that they are instruments which directly and immediately govern all social behaviour. In economics, formalism starts from the view that its primary concern is the analysis of exchange or 'markets', and elevates this into a theory of human history and society based on individual choice.

We begin by showing that, although Coase was very aware of the epistemological limits of neo-classical economics, and tried to remedy this by grounding his work in empirical studies, the concept of transaction costs which he pioneered has paradoxically provided a basis for the extended application of neo-classical economic methodology to all social institutions. Thus, in place of a careful analysis of the social and legal context of economic activity, towards which Coase could have pointed, the dominant strand in law and economics led by Posner has sought to subject all human interaction to analysis based on the crudest forms of economic calculation. These theories became influential within a specific social and political context, from the 1960s to the 1980s, as part of the remodelling of the character and roles of the state, the market and the firm, and the emergence of new forms of regulation. Regulation, we go on to argue, should be conceptualised in the light of perspectives which attempt to transcend legal formalism. These see the law not as fixed rules directly governing behaviour, but as involving uncertain and contested processes of interpretation in the application of principles of fairness and justice, mediated by specialist professionals, but also interacting with and influenced by informal normative expectations and social practices of relevant social groups and communities. To illustrate this, we re-interpret the empirical study carried out by Robert Ellickson to test the paradigmatic example of law and economics, cattle-trespass. Finally we argue that although the new institutional economics has much to commend it, especially in comparison to the blinkered prejudices of Posnerism, it would have much to gain by reclaiming its antecedents in 'old' institutionalism. While the 'new institutionalists' have based their analyses on richer understandings of human behaviour and its social environment than is usual within neo-classical assumptions, they still start from a view of economic activity as consisting of exchange, which is hard to justify in either ontological or common sense terms.

² An excellent start has been made in N. Duxbury in *Law, Economics and the Legacy of Chicago*, Hull Studies in Law, 1994 (available from the School of Law, University of Hull, Hull, HU6 7RX, 1994). See also Mark Kelman, *A Guide to Critical Legal Studies* (Cambridge, Mass.: Harvard University Press, 1987), whose argument is in many respects similar to ours, although he has a much broader scope.

THE IMPORTANCE AND AMBIVALENCE OF COASE

Much of the importance of Coase, and the principal reason he has been taken up so enthusiastically, is that he radically restated the scope of economic reasoning, extending it beyond the confines of the 'private' sphere of market transactions. Economic reasoning can also be applied to the interaction of the market both with the political sphere of the state, especially through its main mechanism, the law, and with the business unit, the firm. This entailed an appreciation not only that the state and the firm are also in a sense economic institutions but, even more importantly, that the market must be appreciated as a social institution. However, the limits of Coase are that he does not essentially modify the fundamental tenets underlying neo-classical economic theory. In effect, he does not challenge that theory, but provides a means to defend it, by bringing some realism into its analysis on terms with which it can cope:

In mainstream economic theory, the firm and the market are, for the most part, assumed to exist and are not themselves the subject of investigation. One result has been that the crucial role of the law in determining the activities carried out by the firm and the market has been largely ignored. What differentiates [my writings] is not that they reject existing economic theory, which ... is of wide applicability, but that they employ this theory to examine the role which the firm, the market and the law play in the working of the economic system.³

Coase's own work has been exemplary in the way it analyses the concrete empirical institutional context within which particular economic activities take place. He seeks to use this empirical detail to fill in the gaps between economic analysis as the 'science of choice' based on 'the treatment of man as a rational utility maximiser'⁴ and a more realistic account of human behaviour and economic activity.

The key concept developed by Coase to explain the gap between the world analysed on the basis of economic assumptions and the more realistic one shown by empirical observation has come to be known as 'transaction costs'.

In order to carry out a market transaction, it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up a contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on.⁵

Perfectly efficient markets are markets at zero transaction costs, that is to say with information gathering and communication costless. But information gathering and communication costs will *always* be positive, so that the existence of such markets is a 'very unrealistic

³ R.H. Coase, 'The Firm, the Market and the Law', in R.H. Coase, *The Firm, the Market and the Law* (Chicago: University of Chicago Press, 1988) p. 5. Yet Coase has bitterly complained of hostility from 'standard economists': R.H. Coase, 'The Nature of the Firm: Influence', in O.E. Williamson and S.G. Winter (eds.) *The Nature of the Firm* (Oxford: Oxford University Press, 1991) ch. 5.

⁴ R.H. Coase, 'Economics and Contiguous Disciplines', in R.H. Coase, *Essays on Economics and Economists* (Chicago: University of Chicago Press, 1994) p. 42.

⁵ R.H. Coase, 'The Problem of Social Cost', in Coase, *The Firm, the Market and the Law*, p. 114.

assumption'.⁶ Thus, the thrust of Coase's work is to reject the view of 'the economic system as it is normally treated by the economist'⁷ by demonstrating that 'there is a cost of using the price mechanism'.⁸ He does this in order to *draw attention* to the existence of transaction costs in empirical markets and therefore to call for the explanation of particular markets as *specific social institutions*. After Coase, we can say that neo-classical economic analysis, which typically assumes a market with zero transaction costs, should be used as a guide to economic policy formulation only in the context of an appreciation of the importance of the institutional structure of economic activity, including market transactions. As empirical markets have positive transaction costs, they must be evaluated against alternatives - which generally are considered to boil down to the firm or the state (though a large literature is growing on 'hybrid' forms).⁹

In conceptualising the social setting of market transactions in this way, Coase simultaneously identifies the limits of neo-classical economic analysis while also paradoxically providing a criterion based on that analysis for the evaluation of all social institutions. The ambivalence of Coase lies in that, while he emphasises that a world of zero transaction costs is impossible, he accepts the application of a methodology based on the assumption of its existence. The important corollary of this is that the design of social institutions should be aimed at the reduction of transaction costs. Yet in Coase's work this is a paradoxical and confusing goal because, though the core of his work is to stress that it is an unobtainable goal, he appears not to understand why. The negotiating, information gathering, organising, etc. within which transactions take place are not only costs, they are also the social relations which are essentially facilitative of the transaction. Negotiation is a cost, but what contract could be made without language? Information gathering is a cost, but what contract could be made in complete ignorance? All actions, including all transactions, can take place only within constitutive social relations. The stress on the reduction of transaction costs may have an important technical function, but inevitably is carried too far if that is confused, as it typically is in law and economics, with both an analysis of the ontological character of economic action and a normative prescription for the design of social institutions. If one really took away all the costs of exchanging, the exchange would not take place cost free, it would not take place at all. This should tell us that, regardless of its technical usefulness, the transaction cost approach cannot begin to stand either as an understanding of economic activity or as the primary basis for the design of social institutions.

THE BANALISATION OF LAW AND ECONOMICS

While Coase is venerated as the founding theorist of law and economics, its foremost exponent is acknowledged to be Posner. Posner's enormous corpus shows an extraordinary gift for advocacy of market-based solutions to a wide range of issues not only legal but also merely tangential to law, including adoption,¹⁰ aids,¹¹ ageing¹² and art;¹³ - and this is just to

⁶ *Ibid.*

⁷ R.H. Coase, 'The Nature of the Firm', in Coase, *The Firm, the Market and the Law*, p. 34.

⁸ *Ibid.*, p. 38.

⁹ W. Powell, 'Hybrid Organisational Arrangements: New Form or Transitional Development?' (1987) 30 *California Management Review* 67.

¹⁰ E.M. Landes and R.A. Posner, 'The Economics of the Baby Shortage' (1976) 7 *Journal of Legal Studies* 323.

¹¹ T.J. Philipson and R.A. Posner, *Private Choices and Public Health: The Aids Epidemic in an Economic Perspective* (Cambridge, Mass.: Harvard University Press, 1993).

stay within 'a'. However, in boldly and even relentlessly putting forward these solutions, Posner (perhaps necessarily) abandons the nuances of Coase's approach. Posner has utterly committed himself to fostering the economic imperialist movement which has been led by Gary Becker.¹⁴

Becker sees little or no limit to the scope of the applicability of the economic approach, and boldly starts from the assertion that: 'all human behaviour can be viewed as involving participants who maximise their utility from a stable set of preferences and accumulate an optimal amount of information and other inputs in a variety of markets'.¹⁵ It unarguably is Becker's achievement to have developed mathematical techniques which seem decidedly to stretch the behavioural assumptions of neo-classical economics whilst still displaying mathematical rigour of analysis. On this basis he has developed general theories of expenditure of time¹⁶ and of investment in human capital,¹⁷ as well as applying these techniques to areas of human action, particularly crime¹⁸ and familial relationships,¹⁹ which it had seemed far-fetched to regard as essentially economic. However, his work is characterised by a mixture of crude simplicity of motivational analysis and extreme complexity of the mathematics necessary to get that analysis to begin to work. One example of the former should suffice (we leave it to the masochistic to look into the latter):

For most parents, children are a source of psychic income or satisfaction, and, in the economist's terminology, children would be considered a consumption good. Children may sometimes provide money income and are then a production good as well. Moreover, neither the outlays on children nor the income yielded by them are fixed but vary in amount with the child's age, making children a durable consumption and production good.²⁰

Becker has the grace to enter the caveat, '[i]t may seem strained, artificial, and perhaps even immoral to classify children with cars, houses, and machinery', with which one can only agree.²¹ In his work on the family, Becker is building on:

¹² R.A. Posner, *Aging and Old Age* (Chicago: University of Chicago Press, 1995).

¹³ W.M. Landes and R.A. Posner, 'The Economics of Legal Disputes Over the Ownership of Works of Art and Other Collectibles', Chicago Working Papers in Law and Economics, 7/96 (available from the University of Chicago Law School, 1111 E 60th St, Chicago, IL 60637, USA).

¹⁴ J.R. Shackleton, 'Gary S. Becker: The Economist as Empire Builder' in J.R. Shackleton and G. Locksley (eds.) *Twelve Contemporary Economists* (London: Macmillan, 1981) ch. 2; R. Brenner, 'Economics: An Imperialist Science?' (1980) 9 *Journal of Law and Economics* 179; R.D. Cooter, 'Law and the Imperialism of Economics' (1982) 29 *UCLA Law Review* 1258; RD Cooter, 'Law and Unified Social Theory' (1995) 22 *Journal of Law and Society* 50; J. Hirshleifer, 'The Expanding Domain of Economics' (1985) 75 *American Economic Review* 53 and G.J. Stigler, 'Economics: The Imperial Science?' (1984) 86 *Scandinavian Journal of Economics* 301.

¹⁵ G.S. Becker, 'The Economic Approach to Human Behaviour', in G.S. Becker, *The Economic Approach to Human Behaviour* (Chicago: University of Chicago Press, 1976) p. 14.

¹⁶ G.S. Becker, 'A Theory of the Allocation of Time', in G.S. Becker, *The Essence of Becker*, (Stanford: Hoover Institution Press, 1995) ch. 4.

¹⁷ G.S. Becker, *Human Capital* (New York: Columbia University Press, 3rd. edn. 1993).

¹⁸ G.S. Becker, 'Crime and Punishment: An Economic Approach', in Becker, *The Essence of Becker*, ch. 19.

¹⁹ G.S. Becker, *A Treatise on the Family* (Cambridge, Mass: Harvard University Press, rev. edn. 1991).

²⁰ G.S. Becker, 'An Economic Analysis of Fertility', in *The Essence of Becker*, pp. 242-3.

²¹ Becker frequently enters such a reservation, but merely as a prelude to proceeding unabashed with his analyses in exactly the same way. Even his Nobel Lecture begins with a similar hedge: G.S. Becker, 'The Economic Way of Looking at Behaviour' in *The Essence of Becker*, p. 632.

the assumption that when men and women decide to marry, or have children, or divorce, they attempt to raise their welfare by comparing benefits and costs. So they marry when they expect to be better off than if they remained single, and they divorce if that is expected to increase their welfare.²²

This type of argument depends on the tricky assumption that people act 'to increase their welfare'. On the one hand, this concedes that human motivation is not aimed merely at maximising wealth, and that other satisfactions enter into 'welfare'. On the other hand, however, it extends to all human motivations cost-benefit calculations which properly have a much more limited relevance. Even if one allows that they play a part in the way people take many decisions, this does not entail allowing the claim that all action is, or should be, based on such economic calculations.

Working on the assumption that this claim is true is, however, exactly what Posner has done. Taking his line from Becker,²³ Posner has built that line up into an ideology of law and economics, and ignoring or disparaging all objections with various degrees of disingenuousness, he has pushed it everywhere it could possibly go. But just as he has abandoned the theoretical nuances of Coase, Posner has also dispensed with the mathematical rigour of Becker.²⁴ By dispensing with those mathematics, Posner has widened the appeal of the economic gospel, but in doing so he has also removed the inherent check which mathematical modelling places on the miracles that that gospel can claim to have worked.²⁵ It is one thing to produce an elegant formal solution to an abstract problem; quite another to be under the impression that that solution necessarily will have plausibility as a policy prescription in the real world. Thus, the formal assumption that children may in some sense be considered consumer durables leads Posner very directly to consider the possibilities of a market in orphans:²⁶

The facts that many people who are capable of bearing children do not want to raise them, many other people who cannot produce their own children want to raise them, and the costs of production to natural parents are much lower than the value that many childless parents attach to children, suggest the possibility of a market in babies for adoption.²⁷

In more subtle hands than Posner's this argument is by no means as objectionable as in his version,²⁸ but his own initial statement of it sacrificed nuance to vociferance and his subsequent defences must be described as unscrupulous.²⁹ Given the distribution of wealth in

²² *Ibid.*, p. 643.

²³ R.A. Posner, 'Gary Becker's Contribution to Law and Economics' (1993) 22 *Journal of Legal Studies* 211.

²⁴ A. D'Amato, 'As Gregor Samsa Awoke One Morning From Uneasy Dreams He Found Himself Transformed into an Economic Analyst of Law' (1989) 83 *Northwestern University Law Review* 1012.

²⁵ We are grateful to Ian Macneil for this notion of Posner as a theologian.

²⁶ Landes and Posner, 'The Economics of the Baby Shortage', 323: 'The baby shortage would be considered an intolerable example of market failure if the commodities were telephones rather than babies'.

²⁷ R.A. Posner, *Economic Analysis of Law* (Boston: Little Brown, 4th. edn. 1992) p. 151.

²⁸ N. Duxbury, 'Law, Markets and Valuation' (1995) 61 *Brooklyn Law Review* 657 and N. Duxbury, 'Do Markets Degrade?' (1996) 59 *Modern Law Review* 331.

²⁹ A great deal of Posner's later work is an attempt doggedly to defend, against criticism to which he has always been ready to reply but always loathe to take on board, various positions it would have been wise not to have staked out so brazenly in the first place. We give one example in this paper. Cf. D. Campbell, 'Ayres Versus Coase: An Attempt to Recover the Issue of Equality in Law and Economics' (1994) 21 *British Journal*

the US, if Posner's adoption proposal was at all effective it must move desirable (healthy, good looking and presumably white) babies into wealthy (presumably white) families,³⁰ and Posner acknowledged the criticism that 'the rich would end up with all the babies, or at least all the good babies'.³¹ His response was to dilute his proposal from 'a market' to the 'limited experimental step'³² of regulating baby selling 'less stringently'.³³ Of course, less stringent regulation of an administrative procedure leaves it as an administrative procedure rather than a market, and so Posner abandoned the essence of his proposal. Indeed, he now denies ever 'advocating a free market in babies'.³⁴ But Posner's treatment of this issue in the second edition of his textbook *did* appear under the heading 'The Legal Protection of Children and the Case for Legalising Baby Sales',³⁵ although the words after 'Children' have been conveniently omitted in later editions.

THE MARKET AND THE STATE

The predilection for market-based solutions for the design of social institutions which is aggressively evident in the dominant law and economics work exemplified by Posner can easily be understood in terms of the politics of the period in which it became to be regarded as compelling. In the 1970s, especially after the economic dislocations triggered by the oil crisis of 1974, the inadequacies of the existing political institutions governing economic activity came increasingly under attack everywhere. This was the context for the revival of the work of Coase (as well as others, notably Hayek) which had its roots in the debates of the previous period, stretching from the 1930s to the 1960s, during which the developed capitalist countries had established more or less 'interventionist' forms for governing business and the economy.

From the 1960s, there was a general re-evaluation of the role of the state in relation to economic activity and theorists from different perspectives put forward critiques of those existing conceptions which accepted a radical separation of the public and private spheres. Underpinning much of the state intervention since the 1930s had been implicit assumptions identifying state action with the public good and market transactions with private economic interests. This was linked to a broadly liberal view which accepted that private interests should be allowed free play, but only up to the point where a more general public good was required to be secured through the state, either by the correction of imbalances of power or by more direct modes of intervention such as state ownership. This conception was common to the broad centre-ground of the political spectrum, which can be described as social-democratic, and it came under attack from various parts of that spectrum, from the radical right³⁶ to the

of Law and Society 445-9.

³⁰ J.M. Cohen, 'Posnerism, Pluralism, Pessimism' (1987) 67 *Boston University Law Review* 105; M. Kelman, 'Production Theory, Consumption Theory and the Ideology of the Coase Theorem' (1979) 52 *Southern California Law Review* 669 and J.R.S. Prichard, 'A Market for Babies?' (1984) 34 *University of Toronto Law Journal* 341.

³¹ Posner, *Economic Analysis of Law*, p. 153.

³² R.A. Posner, 'The Regulation of the Market in Adoptions' (1987) 67 *Boston University Law Review* 64.

³³ *Ibid.*, 72.

³⁴ *Ibid.* 58.

³⁵ R.A. Posner, *Economic Analysis of Law* (Boston: Little Brown, 2nd. edn. 1977) p. 111. Cf. Landes and Posner, 'The Economics of the Baby Shortage' 347.

³⁶ E.g. J.M. Buchanan and G Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1965).

Marxist left.³⁷

However, an improved understanding of the relationship between the public sphere of the state and the private sphere of economic transactions through the market clearly depends on a consideration of the more general social conditions of existence of the apparent radical separation of those spheres. Formalist perspectives, on the other hand, confine themselves to analysing a particular social sphere or aspect of social activity from within the limits of its own surface forms of appearance, abstracted from any consideration of the overall social setting.

The limits of formal neo-classical analysis were, as we have pointed out, well-known to Coase, although he did not go so far as to displace its epistemological assumptions in any radical way. In fact, he developed the concept of transaction costs precisely in order to establish a sounder foundation both to analyse the limits of the market and thence to evaluate state intervention. In this his main target was A. C. Pigou, the central figure in the establishment of 'welfare' economics, which deals with the effectiveness and limits of the market in satisfying human needs, and with the role of the state in the light of those limits. The first theorem of welfare economics³⁸ is that a market which is fully contingent in that it conforms to the assumptions established by neo-classical micro-economics for general competitive equilibrium will allocate goods perfectly efficiently. Under general competition, goods will be exchanged up to the point where the increase in one person's utilities achieved by further exchange would be more than offset by the diminution in the sum of another person's. At this point of 'Pareto optimality'³⁹ the market is in equilibrium, because there are no further mutually beneficial exchange opportunities; and the crucial point is that it has been brought there by the uncoordinated processes of dispersed decision-making through private exchange. This model provides a powerful justification not only for market-based economic activity but also for liberal political philosophy, which rejects 'patterned principles' of distribution⁴⁰ in favour of the 'pure procedure' of the market⁴¹, since state intervention to impose a 'fair' distribution of goods would distort the efficient distribution which would be reached by voluntary exchanges at general competitive equilibrium.

The most immediate difficulty for this model is an empirical one, that real markets show a decided lack of perfect efficiency. This must in turn be traced to the assumptions on which the model is based,⁴² which may in broad terms be reduced to two.⁴³ The first assumption concerns the behaviour of the households and firms whose actions drive the system of exchange on which the model is based, which is generally referred to as individual utility maximisation.⁴⁴ The model requires those actions to display the internal rationality of complete commitment to individual utilities; it can cope only with action based on very simple

³⁷ E.g. S. Clarke (ed.) *The State Debate* (London: Macmillan, 1991).

³⁸ K.J. Arrow, 'Pareto Optimality with Costly Transfers', in K.J. Arrow, *Collected Papers*, vol 2 (Cambridge, Mass.: Belknap Press, 1983) p. 290.

³⁹ V. Pareto, *Manual of Political Economy* (New York: Augustus M. Kelley, 1971) ch. 6, se. 33.

⁴⁰ R. Nozick, *Anarchy, State and Utopia* (New York: Basic Books, 1974) pp. 155-60.

⁴¹ J. Rawls, *A Theory of Justice* (Cambridge, Mass.: Belknap Press, 1971) pp. 83-90.

⁴² F.H. Knight, 'Some Fallacies in the Interpretation of Social Costs', in K.J. Arrow and T. Scitovsky (eds.) *Readings in Welfare Economics* (London: George Allen and Unwin, 1969) pp. 226-7

⁴³ Arrow, 'Pareto Optimality with Costly Transfers', p. 291.

⁴⁴ H.H. Gossen, *The Laws of Human Relations* (Cambridge, Mass.: MIT Press, 1983) ch. 7; W.S. Jevons, *The Theory of Political Economy* (Harmondsworth: Penguin Books, 1970) ch. 4; C. Menger, *Principles of Economics* (New York: New York University Press, 1981) ch. 5, sec. 3 and L. Walras, *Elements of Pure Economics* (Philadelphia: Orion Editions, 1983) lesson 3.

utility maximisation.⁴⁵ The second assumption is the existence of all relevant markets. Perfectly rational exchange of a widget requires not merely a physical market in widgets, but markets for all inputs into its production, as well as markets for the risks of non-delivery, and for post-delivery risks such as a fall in demand for products using widgets or variations in the price of the means of payment for the exchange. The equilibrium of all these necessary ‘contingent markets’ can be theoretically demonstrated,⁴⁶ but their actual existence requires full availability of all the information affecting all these exchanges and it is, of course, sheer fantasy to assume this will ever actually be the case.

As we have shown, Coase was fully aware of the limitations of the model based on these assumptions, and highly critical of the abstract analyses of ‘blackboard economics’ which simply accepted that it described the real world.⁴⁷ However, Coase did not advocate any radical modification either to the model or to the assumptions behind it. Rather, he focused on the obstacles impeding the formation of efficient markets according to that model. He urged economists to study the actual operation of real markets, and in doing so to clarify the social conditions of their existence, in particular the nature and role of the firm and the state.

[In] modern economic analysis ... the growing abstraction of the analysis...does not seem to call for a detailed knowledge of the actual economic system, or, at any rate, has managed to proceed without it ... What is studied is a system which lives in the minds of economists but not on earth. I have called the result ‘blackboard economics’. The firm and the market appear by name but they lack any substance. The firm in mainstream economic theory has often been described as a ‘black box’. And so it is. This is very extraordinary given that most resources in a modern economic system are employed within firms. ... Even more surprising, given economists’ interest in the pricing system, is the neglect of the market, or more specifically of the institutional arrangements which govern the process of exchange. As these institutional arrangements determine to a large extent what is produced, what we have is a very incomplete theory.⁴⁸

Coase’s aim was to treat not only the market but also the firm and the state as social institutions, the operation of which could be analysed using economic methodology. However, since the methodology he applied largely accepted the assumptions of the neo-classical theory of efficient markets, his analysis tended to show how both the firm and the state are, or should be, essentially complementary to and facilitative of market processes.

The paradoxical nature of Coase’s method is most revealingly and unfortunately evident in the structure of what has proved to be his most influential paper, ‘The Problem of Social Cost’.⁴⁹ In its first part, the analysis proceeded on the assumption that ‘there were no

⁴⁵ A.K. Sen, ‘Rational Fools: A Critique of the Behavioural Foundation of Economic Theory’ (1977) 6 *Philosophy and Public Affairs* 317.

⁴⁶ K.J. Arrow and G. Debreu, ‘Existence of Equilibrium for a Competitive Economy’, in Arrow, *Collected Papers*, vol 2, pp. 220-2.

⁴⁷ R.H. Coase, ‘The Theory of Public Utility Pricing and Its Applications’ (1970) 1 *Bell Journal of Economics and Management Science* 119.

⁴⁸ R.H. Coase, ‘The Institutional Structure of Production’, in R.H. Coase, *Essays on Economics and Economists*, pp. 5-6.

⁴⁹ Indeed, a survey of the Social Sciences Citation Index (which covers law, economics, and social science

costs involved in carrying out market transactions'.⁵⁰ This was the source of what was later described as the Coase Theorem, a phrase apparently coined by Stigler, who defined it as the claim that 'under perfect competition private and social costs will be equal'.⁵¹ What is too often neglected is that the second part of Coase's famous paper drops the assumption of zero transaction costs in order to evaluate alternative governance structures to the market, and, to the extent that 'The Problem of Social Cost' advances any concrete policy proposals, it is that the state is best fitted to handle certain forms of pollution:

It is clear that an alternative form of economic organisation which could achieve the same result at less cost than would be incurred by using the market would enable the value of production to be raised. ... [T]he firm represents such an alternative to organising production through market transactions. Within the firm, individual bargains between various co-operating factors of production are eliminated and for a market transaction is substituted an administrative decision. ... This solution would be adopted whenever the costs of the firm were less than the costs of the market transaction that it supersedes. ... But the firm is not the only answer to this problem. The administrative costs of organising transactions within the firm may also be high, and particularly so when many diverse activities are brought within the control of a single organisation. In the standard case of a smoke nuisance, which may affect a vast number of people engaged in a wide variety of activities, the administrative costs might well be so high as to make any attempt to deal with the problem within the confines of a single firm impossible. An alternative solution is direct governmental regulation. ... It is clear that the government has powers which might enable it to get some things done at a lower cost than could a private organisation. ... But the governmental administrative machine is not itself costless. It can, in fact, on occasion be extremely costly. ... From these considerations it follows that direct governmental regulations will not necessarily give better results than leaving the problem to be solved by the market or the firm. But equally there is no reason why, on occasion, such governmental regulation should not lead to an improvement in economic efficiency. This would seem particularly likely when, as is normally the case with the smoke nuisance, a large number of people is involved and when therefore the costs of handling the problem through the market or the firm may be high.⁵²

Responding later to the way in which 'The Problem of Social Cost' was received, Coase has said: 'The world of zero transaction costs has often been described as a Coasean

journals) of the period 1981-88 showed that this was by far the most cited article published in a law review: R.C. Ellickson, *Order Without Law. How Neighbours Settle Disputes* (Cambridge, Mass.: Harvard University Press, 1991) p. 2, n. 2.

⁵⁰ Coase, 'The Problem of Social Cost', p. 114.

⁵¹ G.J. Stigler, *The Theory of Price* (New York: Macmillan, 3rd. edn. 1966) p. 113. While not denying the ideas behind it, Coase has always been anxious to disavow authorship of the phrase. Stigler said of the Coase Theorem: 'If this proposition strikes you as incredible on first hearing, join the club. The world of zero transaction costs turns out to be as strange as the physical world would be without friction'. (G.J. Stigler, 'The Law and Economics of Public Policy: A Plea to the Scholars' (1972) 1 *Journal of Legal Studies* 12. Cf. G.J. Stigler, 'Two Notes on the Coase Theorem' (1989) 99 *Yale Law Journal* 631).

⁵² Coase, 'The Problem of Social Cost', pp. 115-8.

world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave'.⁵³ Yet much of the law and economics literature has been based on precisely this approach, not least that of Posner, about whose version of Coase's ideas Coase himself has been extremely scathing.⁵⁴

Nevertheless, Coase must be regarded as partly responsible for the aberrances of law and economics, due to his methodology of criticising the conclusions of neo-classical economic analysis by using the tools of that analysis. His intention was to provide a new approach to analysing the role of the state, as he wrote in 1991:

I regard the Coase Theorem as a stepping stone on the way to an analysis of an economy with positive transaction costs. The significance to me of the Coase Theorem is that it undermines the Pigovian system. Since standard economic theory assumes transaction costs to be zero, the Coase Theorem demonstrates that the Pigovian solutions are unnecessary in these circumstances. Of course, it does not imply, when transaction costs are positive, that government actions ... could not produce a better result than relying on negotiations between individuals in the market. Whether this would be so could be discovered not by studying imaginary governments but what real governments actually do.⁵⁵

Coase's criticism of the Pigovian approach was that it tended to treat the market and the state as simple alternatives. In Pigou, state action was deduced to be necessary as a substitute for market transactions where there may be 'market failure' due to what were later described as 'externalities'. These were considered to occur when there are 'social costs', in the sense that they are external to the parties actually involved in the market transactions.⁵⁶ In such circumstances the typical solution advocated would be public investment through the

⁵³ R.H. Coase, 'Notes on the Problem of Social Cost', in Coase, *The Firm, the Market and the Law*, p. 174.

⁵⁴ At the Tenth Annual Conference on New Institutional Economics, responding to what Posner had apparently intended to be a eulogistic account of Coase's ideas, Coase commented (R.H. Coase, 'Coase on Posner on Coase' (1993) 149 *Journal of Institutional and Theoretical Economics* 96):

My first reaction on reading Posner's paper was one of amusement. It recalled to my mind Miss Elliott's description of Alfred Marshall's lectures on Henry George. She said that Marshall reminded her of a boa-constrictor that slobbered over its victim before swallowing it. In saying this, I had no intention of equating Posner with Marshall, still less with any kind of snake, although I did confess that the wicked thought did flicker through my mind as I studied his paper with more care and ceased to be amused. Posner says that the first part of his paper describes 'the conception of the field [the new institutional economics] held by Ronald Coase.' Reading this part of his paper recalled to my mind Horace Walpole's opening remarks in his book on King Richard the Third: 'So incompetent has the generality of historians been for the province they have undertaken, that it is almost a question, whether, if the dead of past ages could revive, they would be able to reconnoitre the events of their own times, as transmitted to us by ignorance and misrepresentation.' I have only one foot through the door, but should the final yank come before this piece is published, Horace Walpole's words would apply exactly to Posner's highly inaccurate account of my views.

Posner nevertheless allowed a paper on which he was then working which sought to expound Coase's views on methodology to be published: R.A. Posner, 'Nobel Laureate: Ronald Coase and Methodology' (1993) 7 *Journal of Economic Perspectives* 195.

⁵⁵ Coase, 'The Institutional Structure of Production', p. 11.

⁵⁶ Coase, 'The Firm, the Market and the Law', pp. 23-4. A typical example is pollution caused by a factory, which causes harm to persons who are not party to any of the transactions involved in producing or consuming the factory's products.

state to produce the necessary ‘public goods’. Coase was able to attack this approach, not least because he could show that Pigou typically failed to inquire into the actual working of state institutions but rather worked by ‘assuming the existence of (almost) perfectly functioning public bodies’.⁵⁷ In contrast, Coase developed his theoretical analysis from his empirical studies of actual economic institutions, particularly those for broadcasting. He then hammered home the message of that analysis in a devastating way in ‘The Lighthouse in Economics’, showing not only the woolly nature of the arguments of economists (from J. S. Mill via Pigou to Paul Samuelson) for treating lighthouses as necessarily public goods, but also, through a detailed history of the provision of this service in Britain, that it was long provided privately, financed by charges on ships rather than from general taxation.

There is certainly nothing in the transaction costs approach that denies the important role of the state. At its best it provides a basis for analysing alternative governance mechanisms, none of which will work perfectly.⁵⁸ But in what may be regarded as the distorted form of the Coase Theorem, it has found very many uses, most of which we cannot begin to discuss here,⁵⁹ and has become a complicated and silly way of saying something initially quite simple. In our opinion, the Coase Theorem is now so unproductive that it should be abandoned.⁶⁰ It is actually pernicious where it used to sanction a more or less general claim that allocations are more efficient the more they are left to ‘free’ market forces without any state ‘interference’.⁶¹ This occurs when, instead of taking the ‘zero transaction costs postulate’ as a stage in the analysis, it is assumed that empirical markets will tend to be markets at zero transaction costs. The result, unsurprisingly, is a demonstration of the superiority of the market, based on a comparison between a market assumed to be perfectly efficient and a state known not to be so. This bias towards the market is just the opposite error to Pigou’s ‘assuming the existence of (almost) perfectly functioning public bodies’.

A preference for state intervention by means of the creation of property rights tends to flow from the concept of ‘transaction costs’, which entails a rather limited characterisation of

⁵⁷ Coase, ‘The Firm, the Market and the Law’, p. 22. Although Coase was extremely hostile to Pigou, his treatment of the latter’s ideas seems to us to have been fair, but see *contra* A.W.B. Simpson, ‘Coase v Pigou Reexamined’ (1996) 25 *Journal of Legal Studies* 53. This is not to say that Coase comes particularly well out of the subsequent exchange with Simpson, where Coase’s usual balance and wit seems to desert him. Coase, ‘Law and Economics and A.W. Brian Simpson’ and A.W.B. Simpson, ‘An Addendum’ (1996) 25 *Journal of Legal Studies* 99.

⁵⁸ For an exemplary exchange of views see G. Calabresi and A.D. Melamed, ‘Property Rules, Liability Rules and Inalienability: One View of the Cathedral Crypt’ (1972) 85 *Harvard Law Review* 1089 and P. Burrows, ‘Nuisance, Legal Rules and Decentralised Decisions: A Different View of the Cathedral Crypt’, in P. Burrows and C.J. Veljanovski (eds.) *The Economic Approach to Law* (London, Butterworths, 1981) ch. 6.

⁵⁹ Surveys are provided by R.D. Cooter, ‘The Coase Theorem’, in J. Eatwell *et al* (eds.) *The New Palgrave*, London, Palgrave, 1987, p. 457-60; G. Daly, ‘The Coase Theorem: Assumptions, Applications, Ambiguities’ (1974) 12 *Economic Inquiry* 203 and R.O. Zerbe, ‘The Problem of Social Cost in Retrospect’ (1980) 2 *Research in Law and Economics* 83.

⁶⁰ R.D. Cooter, ‘The Cost of Coase’ (1982) 11 *Journal of Legal Studies* 1; C. Fried, *Right and Wrong*, (Cambridge, Mass.: Harvard University Press, 1978) ch. 4; D. Kennedy, ‘Cost-benefit Analysis of Entitlement Problems: A Critique’ (1981) 33 *Stanford Law Review* 33; D.H. Regan, ‘The Problem of Social Cost Revisited’ (1972) 15 *Journal of Law and Economics* 427 and L.H. Tribe, ‘Technology Assessment and the Fourth Discontinuity: The Limits of Instrumental Rationality’ (1973) 46 *Southern California Law Review* 617.

⁶¹ Posner, for example, would apparently largely dispense with antitrust (R.A. Posner, *Antitrust Law: An Economic Perspective*, Chicago: University of Chicago Press, 1976), with most utility regulation (R.A. Posner, ‘Natural Monopoly and Its Regulation’ (1969) 21 *Stanford Law Review* 548) and perhaps with legislation altogether (R.A. Posner, *Economic Analysis of Law*, pp. 523-4).

the nature and purposes of social institutions, especially as exemplified in the Coase Theorem. It is not difficult, therefore, to account for its success during a period where state provision, either through public ownership, structural constraints, or direct price controls, has been under attack. Many of these criticisms have been amply justified by the failures of state provision resulting from bureaucratic rigidity and the consequent disinclination to innovate or improve efficiency. We have no space here to discuss either the criticisms of state provision or the range of alternatives which have been devised or implemented. The international nature of the process and its relationship to what is often described as 'globalisation' are equally beyond the scope of this paper.⁶² What we would like briefly to consider, however, is the emergence or revival of new forms of governance of economic activity based on 'regulation', and the ways in which this has been buttressed, often without adequate analysis, by law and economics. In doing so we will also examine the other side of the dualism of law and economics, legal formalism.

EXPLAINING REGULATION: THE LIMITS OF FORMALISM

The past two decades have seen a widespread process of re-negotiation and redefinition of the boundaries between, and indeed the nature and forms of, the state, the market and the firm. There has been not only a reduction in the areas in which some goods and especially services are provided by directly state-owned or public bodies (such as energy, transport and prisons), but also the introduction into many areas of publicly-administered provision (such as health-care, low-cost housing and education) of extensive elements of 'market' transacting.⁶³ This has been accompanied by a significant liberalisation, in the sense of the reduction of barriers between markets (both within and between states) and the ending of many types of structural controls.

Although this process was usually described as involving 'deregulation', it is now widely accepted that this is a serious misnomer. Indeed, there has been a major growth in regulation, in the sense of the governance of economic activity through formalised laws and public bodies which define markets, specify the terms of competition, adjudicate between rivals, and so on. Much of this entails a development and international transplantation of a type of 'regulated corporatism' which emerged in the USA during the Progressive Era (*circa* 1890-1920)⁶⁴ and was consolidated in the 1930s during the Roosevelt period. However, in the USA also, many of these structures have been undermined and further transformed through an interaction of changes in the character, strategies and control of large enterprises, propelled by shifts in state regulation⁶⁵ and an activation of competition, notably in financial markets.⁶⁶

⁶² E.g. G. Majone (ed.) *Deregulation or Re-Regulation. Regulatory Reform in Europe and the United States*, (New York: St Martin's Press, 1990); W. Bratton *et al* (eds.) *International Regulatory Competition and Coordination* (Oxford: The Clarendon Press, 1996) and Sol Picciotto, 'Fragmented States and International Rules of Law' (1997) 6 *Social & Legal Studies* ??.

⁶³ E.g. D. Campbell and P. Vincent-Jones (eds.) *Contract and Economic Organisation* (Aldershot: Dartmouth Press, 1996) pt. 2.

⁶⁴ M.J. Sklar, *The Corporate Reconstruction of American Capitalism 1890-1916. The Market, Law and Politics* (Cambridge: Cambridge University Press, 1988) and J. Weinstein, *The Corporate Ideal in the Liberal State 1900-1918* (Boston: Beacon, 1968). In other leading capitalist countries the state played a more direct role in that period. In Germany, this took place within a formalised framework which included state-supervised cartels, whereas in the U.K., the longer history of the centralised state and the greater homogeneity of ruling elites permitted much more informal supervision of business and industry.

⁶⁵ N. Fligstein, *The Transformation of Corporate Control* (Cambridge, Mass.: Harvard University Press, 1990).

The concerns of law and economics are clearly central to these processes, yet most of its analyses have been unhelpful either in explaining them or, perhaps more importantly, in providing an adequate basis for evaluating the changes and policy alternatives presented. We have seen that one reason for this is the built-in bias towards market-based solutions, due to the acceptance of the assumptions for efficient markets derived from formalist economics. We suggest that adequate explanation and analysis has also been seriously hindered by the acceptance of formalist legal perspectives.⁶⁷ Professor Goodhart partly suggests this in his Chorley Lecture when he points out that economists tend to take the law for granted because they consider it to be a 'given constant' which 'varies only occasionally and then in discrete jumps' (p.8). This certainly is so, but the problem is far greater than this.

A wide range of philosophical and social theoretical views of law have criticised the concept of law as consisting of rules with a fixed and determinable meaning, which directly govern human conduct. For some this stems from the imprecision of language, which leads into debates within linguistic philosophy about the social context of meaning. A more radical perspective, originating with the Legal Realists, has been developed by critical legal scholars (CLS) and post-modernists, who argue that legal doctrine is incoherent and contradictory, an unstable and highly contingent patchwork of concepts, the actual content of which must be supplied by the subjective economic or political prejudices of the judge or decision-maker. These views focus on the structure of legal doctrine and the process of interpretation, but contingency is given a much wider significance in the sociological theory of law.

The important point, too often neglected in legal theory, is that the problem of the indeterminacy of formal law is not merely linguistic, but rooted in the structures of social relations, including their economic aspects. As Max Weber showed so clearly, formal-rational principles of law developed historically with the emergence of capitalism, to underpin the conditions of competitive exchange. Their continuing importance is seen in the current stress on the importance for capitalist development of the 'rule of law', not only in the 'transitional economies' of Eastern Europe and the former Soviet Union (to which Professor Goodhart refers, p.9), but also in the so-called 'developing countries', as is attested by the new importance which the World Bank has now given⁶⁸ to the question of 'governance' and the state in those countries.⁶⁹ There is an understandable and even laudable concern in such discussions with the need to reform state structures which are too often over-blown and bureaucratic, or even arbitrary and corrupt. However, one experiences disappointment with an analysis which largely assumes that the role of public regulation is to provide a neutral framework giving the maximum of latitude to 'market'-based economic activity when, crucially, the point is not *whether* to regulate markets, for they cannot exist without regulation, but *how* to regulate them.

⁶⁶ M. Moran, *The Politics of the Financial Services Revolution. The USA, the UK, Japan* (London: Macmillan, 1991).

⁶⁷ This can also be described as reification, in the sense of abstracting from the concrete, then mistaking the abstract for the concrete: P. Gabel, 'Reification in Legal Reasoning' (1978) 3 *Research in Law and Sociology* 25-51.

⁶⁸ World Bank, *World Development Report 1997. The State in a Changing World* (Oxford: Oxford University Press, 1997).

⁶⁹ D. Campbell, 'What Is Meant By "The Rule of Law" in Asian Company Law Reform?' in R Tomasic (ed.) *Asian Company Law* (Aldershot: Dartmouth Publishing, forthcoming) and in A Czarnota and A Podgorecki (eds.) *Hidden Structures of the Law* (Onāti: International Institute for the Sociology of Law, forthcoming).

The view of law as a social process has led to an ‘interpretivist’ perspective which examines how lawyers as social actors mediate social relationships and the development of social forms through their specific resources and techniques. The practices of resolving differences and conflicts by reference to universalist values contained in general principles may help to generate social consensus and, despite the indeterminacy of doctrinal principles, provide sufficient predictability to stabilise social relations.⁷⁰ Hence, modern legal theory stresses that legal rules are at least moderately indeterminate, and that the uncertainty in legal rules results from the competitive struggle to define the rule and the fact that interpreters can, within certain boundaries, select an interpretation. In this perspective, legal rules are the result of interpretations by regulators and judges who justify their decisions with the aid of rhetorical practices. This contingency of law leads some CLS theorists to argue that law’s legitimacy is suspect since its content depends on political power; whereas pragmatists welcome the flexibility it provides. The crucial point, in our view, is that state law does not act either as directly or unilaterally as is commonly assumed, but is both contestable and mediated.

Law and economics scholars are aware of the critique of formalism,⁷¹ but merely consider that this is a matter of operational uncertainty, increasing the number of variables to be taken into account. Indeed, legal uncertainty is commonly criticised, being identified as a practical problem by business,⁷² while academic commentators have pointed to the enforcement problems generated by ‘creative compliance’ or the exploitation of legal loopholes for regulatory avoidance.⁷³ We go further, and suggest that the key point is that the law is a constantly changing field, modified by the strategies and techniques of the players involved.

This is above all the case for rules governing economic activity. Markets cannot exist without norms or rules of some sort, and the ordering of market transactions takes place through layers of rules, formal and informal.⁷⁴ Rules emerge through the need to mediate economic transactions by reference to a framework of generally understood and articulated expectations about behaviour and conduct. Regulation, in a broad sense, is essential to the

⁷⁰ For a more detailed discussion of different accounts of legal indeterminacy and their implications for the role of lawyering in the development of regulation, see J. McCahery and S. Picciotto, ‘Creative Lawyering and the Dynamics of Business Regulation’, in Y. Dezalay and D. Sugarman (eds.) *Professional Competition and Professional Power. Lawyers, Accountants and the Social Construction of Markets*, (London: Routledge, 1995) pp. 238-74.

⁷¹ R.A. Posner, *The Problems of Jurisprudence* (Cambridge, Mass.: Harvard University Press, 1990) pp. 15-16

⁷² In 1993 a Financial Law Panel was established in London, on the recommendation of the Legal Risk Review Committee set up by the Bank of England, to examine the difficulties caused for London’s financial markets by legal uncertainty. This was due to concern caused by the losses to financial institutions following appeals court decisions holding that local authorities were acting outside their powers in engaging in ‘swap’ transactions. The Committee also identified other problems of uncertainty in the regulation of dynamic and constantly changing markets (Legal Risk Review Committee, Bank of England, *Reducing Uncertainty: The Way Forward*, February 1992 and Legal Risk Review Committee, Bank of England, *Final Report*, 29 October 1992).

⁷³ D. McBarnet, ‘Law, Policy and Legal Avoidance’ (1988) 15 *Journal of Law and Society* 113; D. McBarnet and C. Whelan, ‘The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control’ (1991) 54 *Modern Law Review* 6 and D. Mc Barnet and C. Whelan, ‘Creative Compliance and the Defeat of Legal Control’, in K. Hawkins (ed.) *The Human Face of Law: Essays in Honour of Donald Harris* (Oxford: Clarendon Press, 1997, ch. 8.

⁷⁴ D. Campbell, ‘The Relational Constitution of Contract and the Limits of “Economics:” Kenneth Arrow on the Social Background of Markets’, in S. Deakin and J. Michie (eds.) *Contracts, Co-operation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press, forthcoming).

operation of any system of social organisation. But the generalisation of social relations mediated by commodity circulation resulted in the emergence of a specific form of state, dominating a public sphere of political action separated from the sphere of private economic relations. Despite this apparent radical separation, it is the state which legitimises the definition and allocation of property rights, and ultimately guarantees the enforcement of those rights and their circulation. Hence, it is the combination of private economic relations of exchange through markets and political processes dominated by the state, through which social relations are reproduced. That combination is mediated primarily by money and by law.

A key feature of legal forms of regulation within capitalist market economies generally is that they aim to produce and maintain equalisation of the conditions of competition: hence their basic ideal or feature is equal treatment or rule-fairness in relation to similarly-situated economic actors. However, competition is not a static state but a process, in which the participants seek out advantages. Furthermore, economic actors are quite different in their factor endowments, market power and sunk investments, so rules affect them differently. Hence, the very operation of a formally equal regulatory system produces inequalities resulting from competitive advantage. Hence, an important function of the process of interpretation, application and enforcement of rules is to resolve the persistent antinomies resulting from rule-structured market transactions. For that reason, a regulatory system by nature is not a static given but a continually evolving and dynamic process. The interpretation involved in the application of rules to specific transactions generates modification, supplementation and amendment.

Hence, regulation should not be regarded as a matter external to market transactions, an 'intervention' into otherwise 'free' exchanges, but as an essential part of economic activity itself, generated by the process of exchange. Such transactions may certainly be guided both by rational-technical calculation of economic advantage and by reference to formal legal rules, as well as informal norms and behavioural expectations; but there is no necessary reason for these to be assumed to be self-equilibrating or internally coherent. Indeed, it may be part of the competitive process itself to have recourse to alternative calculations or interpretative evaluations. Nor is there any necessity to resort to an evolutionary sociobiology to justify a view that these imperfect competitive processes will produce 'efficient' outcomes.

LAW, ECONOMICS AND NEIGHBOURLINESS

At this point in our argument, we hope to have shown that the law and economics exemplified by Posner not only fails to transcend but indeed reinforces the limitations of abstract formalist views of both disciplines. As such, it entails an empirically implausible representation of their subject-matter. In this section we seek to illustrate this through a reconsideration of the central parable of law and economics, cattle-trespass. However, we will do so not merely by means of theoretical analysis, which has been done often enough, but also in the light of what we regard as perhaps the most interesting empirical work of recent years in the law and economics vein, Robert Ellickson's study of disputes between neighbours in Shasta County, California.⁷⁵ Having for some years taught land-use law from a law and economics perspective and become dissatisfied with library-based scholarship, Ellickson undertook empirical research that might

⁷⁵ R.C. Ellickson, *Order Without Law: How Neighbours Settle Disputes* (Cambridge, Mass.: Harvard University Press, 1991). An earlier version of the study was published as R.C. Ellickson, 'Of Coase and Cattle: Dispute Resolution among Neighbours in Shasta County' (1986) 38 *Stanford Law Review* 623.

test the famous Coasean analysis of cattle-trespass. In so doing he was following the example of Coase himself who, as we have pointed out, constantly stressed the importance of studying the real-world operation of economists' case-examples.

In 'The Problem of Social Cost,' Coase focuses on two hypothetical examples of a farmer whose crops suffer damage, due to trespass by a neighbouring rancher's cattle, and to sparks from steam locomotives. Coase sought to show that, in a world of zero transaction costs, it would not matter to the ultimate distribution of wealth whether the law imposed liability on the rancher (or the railroad) or left the farmer to bear the loss. Professor Goodhart (p.12) cites the reasoning Coase gives in his 'Notes on 'The Problem of Social Cost'' as follows:

[I]f, for example, the rule of law changed from one in which the ranchers are not liable for the damage inflicted by their cattle to one in which they were liable, the amount which the ranchers would pay for the lease of their land would decrease and owners of ranching land would receive a rebate from those from whom they bought the land, while farmers would have to pay more for the lease of their land and owners of farming land would be required to make an additional payment to those from whom they bought the land.⁷⁶

In the real world it is very implausible indeed that any such set of transactions would take place, and to any lawyer the notion of the rebate in particular is just fanciful, as Professor Goodhart indicates (pp. 13-4).

Professor Goodhart is also correct in finding unconvincing the way in which Posner elaborates the example. Professor Goodhart quotes (p. 13) the following from Posner's textbook:

X buys a farm long before there is a railroad in his area. The price he pays is not discounted to reflect future crop damage from sparks, because the construction of the railroad line is not foreseen. But eventually a line is built and is near enough to X's farm to inflict spark damage on his crops. He sues the railroad but the court holds that the level of spark emission is reasonable because it would be more costly for the railroad than for the farmer to prevent the crop loss. With property values thus exposed to uncompensated depreciation by unforeseen changes in neighbouring land uses, the incentive to invest in farming will be reduced. But...a reduced level of investment in farming may be an efficient adjustment to the possibility that some day the highest value of the farmer's land may be as a dumping ground for railroad sparks.⁷⁷

This conclusion is, as Professor Goodhart rightly says, 'contrary to our personal beliefs in fairness, and in our beliefs in rights and wrongs' (p. 13).

It should be noted, however, that Posner's approach, and his conclusions, are the opposite of Coase's. Posner's deference to large corporations doing as they will - a characteristic feature of his work - is often thought to represent the workings of an efficient market. But there is no market in Posner's example. Posner happily gives the railroad

⁷⁶ RH Coase, 'Notes on the Problem of Social Cost', pp. 172-3.

⁷⁷ Posner, *The Economic Analysis of Law*, p. 54.

company rights for which it does not have to pay, on the basis of a ready assumption that the costs of preventing sparks outweigh the damage to crops.⁷⁸ How he knows this is completely unclear. He cannot know it by the working of a market for he readily ignores the alternative of giving the farmer an alienable right not to be polluted. At the same time, he assumes that the legal system would operate fully rationally and efficiently in adjusting the price of land and hence the level of investment in farming. Coase, in the starkest contrast, emphasises that the situation he initially describes, in which the rights to pollute would have to be traded, is entirely fictitious and that he is analysing what would happen in a perfect bargaining situation, rather than a real world situation. He then goes on to say (in a passage that Professor Goodhart does not quote):

However, once transaction costs are taken into account, many of these measures will not be taken because making the contractual arrangements will not be undertaken because making the contractual arrangements necessary to bring them into existence would cost more than the gain they make possible...The same approach which, with zero transaction costs, demonstrates that the allocation of resources remains the same whatever the legal position, also shows that, with positive transaction costs, the law plays a crucial role in determining how resources are used.⁷⁹

Thus, Coase's conclusion is that it is the law that determines the context for economic decision-making, whereas Posner makes an economic judgement (based on no evidence or analysis) and assumes the law will sort out the consequences.

Ellickson realised that the cattle-trespass issue could be studied in a real-world context since, under California law, liability for damage caused by stray cattle varies according to whether the area is open-range or has been declared closed-range.⁸⁰ In autumn 1981, he was fortunate to find a part of Shasta County which included both open and closed range, partly as a result of earlier conflicts. His application of a careful empirical methodology produced a fascinating case-study. To begin with, he learned that ranching families earn a relatively low income from a lot of hard work; ranching land generally produces only 1-2% financial return on its market value, so when property taxes squeeze the families financially, they resort to selling plots for development as ranchettes.⁸¹ Hence, the economic motivation of wealth-maximisation is only a relatively minor factor in the real-life interactions of farmers, ranchers and their other neighbours.

The main finding was that cattle-trespass problems are generally resolved by those involved without resorting to law, or at least without reference to formal law, but according to

⁷⁸ It is also characteristic that he sees this decision as one taken by a court rather than by a legislature, which might be better equipped to conduct the necessary evaluations.

⁷⁹ Coase, 'Notes on the Problem of Social Cost', p. 175-8 (our emphasis).

⁸⁰ The old common-law rule that an animal owner is liable for damage caused by trespass was widely reversed in mid-19th century America by open-range statutes, which specified that a victim could only recover if land was protected by a 'lawful fence'. But as agriculture developed in the later part of the century, many areas were 'closed', which effectively restored the common-law rule. In California this culminated in the Estray Act of 1915, which closed all but six Counties, one of which was Shasta. In 1945 the California legislature closed part of Shasta by declaring that it was 'not chiefly devoted to grazing' and empowered the County's Board of Supervisors to make similar determinations. Consequently, by 1981, 28 areas of the County had been closed in this way (Ellickson, *Order Without Law: How Neighbours Settle Disputes*, pp. 42-44).

⁸¹ *Ibid.*, pp.20-22.

well-understood informal norms. A stray animal is regarded as a problem to be dealt with on a 'live-and-let-live' basis. All rural residents expect some minor damage from both stray and wild animals, they themselves usually own animals which might stray, and in any case, cattlemen are as concerned about injury to their wayward animals as are farmers about damage to crops. Consequently, a trespassing animal is usually reported by a friendly phone-call and quickly retrieved with an apology. The 'multiplex' nature of social relationships means that neighbours do not ask for compensation, but Ellickson considers that they keep a 'mental account', which they expect will balance in the long run. In relation to individuals who fail to respect these informal norms, and cause repeated incidents by showing indifference or taking inadequate precautions, other action may be taken. This escalates, from informal retaliation (especially negative gossip, but sometimes extending to injuring or killing the invading animal) through to more formal action including resort to the state law.

It is no surprise, certainly to sociologists of law, that the study should show that people prefer to resolve the potential conflicts of everyday life amicably and primarily guided by informal norms.⁸² What is more interesting is the relationship of those norms to state law. Ellickson cogently points out that real-life behaviour contradicts the premises of law and economics, which assume that people accept the law both as an exogenous and a fixed factor, and bargain 'in the shadow of the law' to resolve the allocation of costs.⁸³ In his view, people prefer to resolve matters *outside* the law, not only by refusing in most cases to resort to formal procedures, but by applying informal norms which Ellickson considers are treated as 'trumping' the formal rules of law. In this respect, he sees his study as consistent with Coase's central point that the transaction costs of resorting to formal law are a major hindrance to its effectiveness. Indeed, he criticises Coase for having over-estimated the efficacy of the law and of state action.⁸⁴ Thus, Ellickson considers that his study rejects the assumptions of law and economics,⁸⁵ while his conclusions are a challenge to 'social engineers' and 'law in society' scholars.⁸⁶

However, we consider that a closer examination of Ellickson's own account, in the light of the critiques of formalism mentioned earlier, would significantly enhance his conclusions. Ellickson jumps rather readily from his finding that issues are generally resolved without direct reference to formal law to the argument that this occurs 'outside' the law. This is largely because his own view of law is essentially formalistic.⁸⁷ He examines three legal

⁸² In this respect he bears out the point made by Mark Kelman that in its empirical mode law and economics can be indistinguishable from 'law and society' 'impact' studies: Kelman, *A Guide to Critical Legal Studies*, p. 117.

⁸³ Ellickson, *Order Without Law: How Neighbours Settle Disputes*, p.52. The phrase comes from the well-known article by Robert Mnookin and Lewis Kornhauser, 'Bargaining in the Shadow of the Law: The Case of Divorce' (1979) 88 *Yale LJ* 950.

⁸⁴ This despite Coase's repeated attacks on Pigou for the same error: Ellickson, *Order Without Law: How Neighbours Settle Disputes*, p.281.

⁸⁵ Cf. R.C. Ellickson, 'The Case for Coase and Against "Coaseanism"' (1989) 99 *Yale Law Journal* 611.

⁸⁶ Ellickson, *Order Without Law: How Neighbours Settle Disputes*, ch. 16. In political terms, he sees his study as contributing to the thinking of those such as Hayek 'who have kept alive the Burkean notion' of the importance of decentralised social forces in maintaining spontaneous social order: *ibid.* p. 168.

⁸⁷ Ellickson embarks on his critique of 'law and society theory' by citing approvingly an aphorism attributed to Arthur Leff that while law and economics is a desert, law and society is a swamp (*ibid.*, p.147). This one may readily concede, and it may help to explain why Ellickson does not mention the 'interpretative' turn in law and society work, although he briefly mentions that his argument is contradicted by interpretivism in anthropology and the humanities (Ellickson, *Order Without Law: How Neighbours Settle Disputes*, p.169).

issues involving the stray animal problem: (i) liability for trespass damage, (ii) the cost of fencing, and (iii) highway collisions involving livestock. In relation to each, he begins by expounding 'the law' in traditional textbook manner, then giving an account, derived from interviews, of the 'knowledge' of that law of people in Shasta County, and concludes with an account of the informal norms that 'really' govern the situations. His argument is that although ordinary people have some knowledge of the law, it tends to be in simplified or 'black-and-white' terms. The residents he interviewed were very aware of the broad rule that the cattle-owner is liable for damage in a closed-range area but not in open range, not least because there had been a local furore, six months previously, over the aggressive herding practices of a rancher called Frank Ellis. However, Ellickson shows that 'the law' is more complex than this: notably, there may be a right to recover compensation even in open-range if damage is caused by *intentional* trespass. From his viewpoint, as an academic specialist, ordinary people are not aware of these subtleties; indeed, he shows that the local lawyers' knowledge is even more inaccurate, since they are wedded to negligence principles inappropriate to property law.⁸⁸ In any case, he easily shows that ordinary people generally reject the possibility of resorting to formal legal procedures in relation to everyday incidents, even when they believed (however accurately or inaccurately) that the law might support them, making statements like 'I don't like to create a stink' or 'I try to get along'.⁸⁹ Instead, they resort generally to informal norms, according to which, as we have noted, monetary compensation is not usually paid but neighbours keep a 'mental account'.

However, Ellickson's view that informal dispute-settlement takes place *outside* the law inadequately captures his own account of Shasta County practices. In particular, his characterisation of the relationship between the informal norm and the law rests on a formalistic *interpretation* of the law. The subtleties of the legal rules, which he himself demonstrates, leave open the possibility of interpretations which would be capable of fitting closely with the informal normative expectations expressed by those he interviewed. This open-endedness is especially evident in the characteristically liberal principle of 'intentional trespass', which acts as an exception to the no-liability rule in open-range. Ellickson shows that the informal live-and-let-live norm is not applied to ranchers who come to be considered locally as acting irresponsibly, such as Frank Ellis. In such cases, the informal norm approves a resort to sanctions, which in some cases extends to resort to formal law. In such cases, the legal exceptions to the open-range no-liability rule, especially the principle of liability for intentional trespass, offer an arguable interpretation which would support the informal norm. Indeed, Ellickson recounts two cases, both of which resulted in settlements involving compensation, and in both of which he considers that legal authority favoured the victim.⁹⁰ Similarly, he shows that people are not generally aware of provisions such as s.841 of California's Field Code which formally governs cost-sharing for construction of boundary fences. Yet he concedes that the informal norms (under which costs are generally split in proportion to the numbers of cattle owned, on the basis of contributions of labour and materials but usually with no monetary payment) actually produce a broadly similar result to his interpretation of the state law.⁹¹

In general, although state law influences social behaviour only indirectly, and people

⁸⁸ *Ibid.*, pp. 50-51.

⁸⁹ *Ibid.*, p. 61.

⁹⁰ *Ibid.*, pp. 63-4.

⁹¹ *Ibid.*, p. 75.

rarely resort to formal legal action, it clearly does have an influence, which is sometimes strong. When it comes to the local political battle to declare an area closed-range this influence is apparent, and Ellickson describes this by resorting to the sociological concept of a ‘symbolic struggle’, in which the cattlemen are defending a traditional rural order against an emerging urban rival.⁹² However, here the cattlemen prefer to deploy instrumental arguments (higher insurance premiums), which Ellickson found to be inaccurate (insurance companies apply uniform rates in both open and closed range areas), whereas sociologists have more often seen battles for legislative changes as being waged in symbolic terms while concealing the ‘truer’ instrumental motives.⁹³ The instrumental impact of a new legislative provision clearly depends both on its terms and on how they are applied and interpreted. Thus, political agitation for state intervention entails multiple mediations, not the least of which are the interpretative processes by which formal law is adapted and applied to the complex social situations in which it may be invoked.

An interpretative approach helps to clarify the nature of the interaction between formal, state law, and the layers of semi-formal and informal normative practices which help to structure social life. This is crucial, since clearly state law is normally marginal to the ordinary processes of everyday life but can often exert a decisive influence on them. Equally importantly, the social context can exert an important influence on the application and interpretation of the law. This approach shows that social conflicts are often struggles over meanings which entail giving substantive content to abstract principles of justice and fairness. These interpretative processes are mediated by professionals (notably lawyers) and state officials who claim or are given powers to give authoritative interpretations. In doing so, they are constrained not only by the language of the relevant texts but also by the dynamics of the social contexts in which they are to be applied.⁹⁴ Such perspectives have become commonplace in recent writings on law. However, the alienation of much of this theory from economic considerations (exacerbated by the crude formalism of law and economics) has obscured the important point that interpretative struggles also have important implications for the allocation of resources and the organisation of economic activity.

FINALE: THE ALTERNATIVE PATHS OF INSTITUTIONAL ECONOMICS

The need for a richer analysis of the social context of economic activity was, as we have argued, indicated by Coase’s own *substantive* work, although not by most of his general

⁹² *Ibid.*, pp. 116ff. He refers to the *locus classicus*, Joseph Gusfield’s account of prohibition (J.R. Gusfield, *Symbolic Crusade*, Urbana: University of Illinois Press, 1963). The interaction of instrumental and symbolic aspects of a campaign for legislative reform was explored in Carson’s socio-legal account of the 19th century struggle over the Factory Acts: W.G. Carson ‘Symbolic and Instrumental Dimensions of Early English Factory Legislation’, in R. Hood (ed.) *Crime, Criminology and Public Policy* (London: Heinemann, 1974) pp. 108-20.

⁹³ E.g. H.S. Becker, *Outsiders* (New York: Free Press, rev. edn. 1971) ch. 7.

⁹⁴ Thus, recent socio-legal work on regulation has stressed that it should be considered as a ‘responsive’ or ‘reflexive’ process, involving an interaction among the layers of formal and informal regulatory arenas. This at least requires consideration of how to design state or public regulation to interact effectively with informal or private normative practices (e.g. I. Ayres and J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press, 1992). Ellickson also examines this in the later part of *Order Without Law*). However, it is also important to understand how this interaction operates through an interpretative process involving the construction of authoritative meanings: see e.g. N. Reichman, ‘Moving Backstage: Uncovering the Role of Compliance Practices in Shaping Regulatory Policy’, in K. Schlegel and D. Weisburd (eds.) *White Collar Crime Reconsidered* (Boston: Northeastern University Press) pp. 244-268, esp. pp. 256ff.

theoretical statements. This line has been developed by the ‘new institutionalist’ economists, led by Oliver E. Williamson, who, with Coase’s endorsement,⁹⁵ have endeavoured to expand on his intellectual legacy.⁹⁶ The term ‘institutionalist’ acknowledges the emphasis that Coase himself placed on the institutional context of economic action and the adjective ‘new’ is used to distinguish this work from the ‘old’ institutional economics which gained prominence during the Progressive Era.⁹⁷ In those economics, formal rigour was eschewed in favour of detailed appreciation of the institutional structure of the economic system,⁹⁸ and particularly the legal constitution of that system.⁹⁹ This work is of great interest, is rightly undergoing something of a revival at present,¹⁰⁰ and cannot be too highly recommended.¹⁰¹

Coase himself, however, had no time whatsoever for the ‘dreary subject’ of old institutional economics, and one of the reasons he gave for this was that ‘it had no positive doctrines’ but only ‘a stance of hostility to the standard economic theory’.¹⁰² Here we consider him to be mistaken. One may indeed struggle to detect any sort of general economic theory in some quite minor figures or in some major but very confusing figures of institutionalism. However, one has such a theory thrust at one by Veblen,¹⁰³ the proximate source of institutionalism, and Veblen’s theory of instincts was given a most interesting restatement by one of the leading institutionalists, Clarence Ayres.¹⁰⁴ What is more, this is a puzzling mistake for Coase to have made. Not only can one find aspects of institutionalism to which Coase should have been very sympathetic, such as Commons’ thorough knowledge of the law, but Coase’s own work, as we have mentioned,¹⁰⁵ is intrinsically critical of ‘mainstream economic theory’

It seems that the real issue for Coase must have been not that old institutionalism lacked a theory but that its theory rejected neo-classical economics as a general social scientific methodology and, behind this, the price system as the basis of social solidarity. For Coase, both of these positions were anathema. He always sought to ensure that his work was ‘operational’ in the sense of being amenable to expression and use in neo-classical terms.¹⁰⁶ Coase obviously believed that achieving this entailed being sympathetic to Becker’s economic imperialism. As what is most valuable in his own work shows, it does not.

Coase has made an immense contribution by establishing the institutional prerequisites of rational economic action but he does not think it necessary to explain rational economic action itself as an institution or, better, as a specific form of action constituted within specific

⁹⁵ Coase, ‘Coase on Posner on Coase’, 98 and R.H. Coase, ‘Concluding Comment’ (1993) 149 *Journal of Institutional and Theoretical Economics* 361.

⁹⁶ Williamson, *The Mechanisms of Governance*.

⁹⁷ A.G. Gruchy, *The Reconstruction of Economics* (New York, Greenwood Press, 1987) and G.M. Hodgson, *Economics and Institutions* (Philadelphia, University of Pennsylvania Press, 1988).

⁹⁸ T. Veblen, *The Theory of Business Enterprise* (New York: Mentor Books, 1958).

⁹⁹ J.R. Commons, *The Legal Foundations of Capitalism* (New York, Macmillan, 1924).

¹⁰⁰ G.M. Hodgson, ‘The Return of Institutional Economics’, in N.J. Smelser and R. Swedberg (eds.) *The Handbook of Economic Sociology* (New York, Princeton University Press, 1994) ch. 3.

¹⁰¹ Campbell, ‘Ayres versus Coase: An Attempt to Recover the Issue of Equality in Law and Economics.’

¹⁰² R.H. Coase, ‘The New Institutional Economics’ (1984) 140 *Journal of Institutional and Theoretical Economics* 229.

¹⁰³ T. Veblen, *The Instinct of Workmanship* (New York, Augustus Kelley, 1964).

¹⁰⁴ CE Ayres, *The Theory of Economic Progress*, 3rd. edn. (Kalamazoo, New Issues Press, 1978).

¹⁰⁵ N 3 *supra*.

¹⁰⁶ Coase, ‘The Nature of the Firm’, p. 34.

social relations.¹⁰⁷ This, however, is precisely what is needed. Further development of the employment of neo-classical technique requires that it be put to work within a sound, sociological framework.

The principal attempt to do this within economics is, however, precisely the 'old' institutionalism which Coase rejects.¹⁰⁸ Whilst we do not wish to claim that an adequate social theory may be found within that body of thought, what can be found is an acknowledgement of the necessity of the development of such a theory as a condition for the further development of economics. By attempting to associate his work with that of Becker, Coase undercuts what is best in his work. Coase's work requires a full account of the institutions of capitalist exchange and yet Becker places the principal such institution, the technical-rational orientation of economic action, beyond the range of economic (or social) analysis by locating it within the assumptions of rational utility maximisation that are identified with human action as such. What is at issue has been clearly enough identified by Ayres:

What was most basically wrong with the conception of the economy in terms of 'enlightened self-interest' and the 'self-regulating market' was the whole conception of the nature of man and society of which that conception of the economy was a particular expression. The error, fundamental as it is, can be stated very simply and briefly...the nature of man was presumed to be antecedent to organised society. Thus society in general and the economy in particular were conceived to derive their character from the pre-existent character of man. The whole conception of the nature of man and society is now known to be quite false. Human nature as we know it is not antecedent to society. On the contrary, it is a function of society.¹⁰⁹

Old institutionalism accordingly contains a number of accounts of the historical development of the capitalist economy and of the orientation of action on which that economy turns that are of real interest. When, by comparison, we turn to what Coase tells us of capitalist development, we find statements such as the following:

Like galaxies forming out of primordial matter, we can imagine the institutional structure of production coming into being under the influence of forces

¹⁰⁷ D.C. North, 'Institutions and Credible Commitment' (1993) 149 *Journal of Institutional and Theoretical Economics* 11.

¹⁰⁸ Campbell, 'Ayres Versus Coase: An Attempt to Recover the Issue of Equality in Law and Economics,' C Gunnarsson, 'What is New and What is Old in New Institutional Economics?' (1991) 39 *Scandinavian Economic History Review* 43; V.P. Goldberg, 'Commons, Clark and the Emerging Post-Coasian Law and Economics' (1976) 10 *Journal of Economic Issues* 877; G.M. Hodgson, 'Institutional Economic Theory: The Old Versus the New' (1989) 1 *Review of Political Economy* 249; G.M. Hodgson, 'Institutional Economics: Surveying the 'Old' and the 'New'' (1993) 44 *Metroeconomica* 1; H. Hovenkamp, 'The First Great Law and Economics Movement' (1990) 42 *Stanford Law Review* 993; H. Hovenkamp, 'Law and Economics in the United States' (1995) 19 *Cambridge Journal of Economics* 333-4; T.W. Hutchison, 'Institutional Economics Old and New' (1984) 140 *Journal of Institutional and Theoretical Economics* 20; M.C. Rutherford, 'What is Wrong with the New Institutional Economics (And What Is Still Wrong with the Old)' (1989) 1 *Review of Political Economy* 299; W.J. Samuels, 'Law and Economics', in G.M. Hodgson *et al* (eds.) *The Edward Elgar Companion to Institutional and Evolutionary Economics* (Aldershot: Edward Elgar, 1994) pp. 8-12; W.J. Samuels, 'Institutionalism, 'Old' and 'New,''' in Hodgson *et al* (eds.) *The Edward Elgar Companion to Institutional and Evolutionary Economics*, pp. 397-402 and W.J. Samuels, 'The Present State of Institutional Economics' (1995) 19 *Cambridge Journal of Economics* 569.

¹⁰⁹ C.E. Ayres, *The Industrial Economy* (Boston: Houghton Mifflin, 1952) pp. 10-1.

determining the interrelationships between the costs of transacting and the costs of organising. These relationships are extremely complex, involving...pricing practices, contractual arrangements, and organisational forms.¹¹⁰

In these statements, from the new prefatory chapter which Coase added to the collection of his papers published in 1988 as *The Firm, the Market and the Law*, Coase makes a claim for the general applicability of economic analysis of 'choice' to all human action which clearly is wholly sympathetic to Becker. He apparently looked forward to the unification of economics with what he believed to be the natural sciences, and indeed to the complete mathematisation of the unified science,¹¹¹ so that economics would embrace all sentient creatures (including the 'rat, the cat and the octopus').¹¹²

Despite the inadequacies of the epistemological basis of neo-classical economics, it has received distinguished if very limited support from other social sciences, even sociology. The principal attempt to elaborate essentially Becker's position within sociology is the 'rational choice theory' of James Coleman. Coleman's recent *Foundations of Social Theory*¹¹³ magisterially sums up 40 years of distinguished work, but we cannot call to mind a less convincing brilliant book. It is a paradigmatic expression of the broad methodology lying behind much law and economics in that its specific character resides in merely *overstating* an otherwise interesting claim about the usefulness of appreciating the exchange dimensions of action. This is so even though the argument had been set out in a balanced way in a group of works traceable to Homans¹¹⁴ of which Blau's *Exchange and Power in Social Life*¹¹⁵ is now the most well known.

Coleman's support for the world-view of neo-classical economics is highly appreciated in Chicagoan law and economics, all the more perhaps as it represents a capitulation by an eminent sociologist.¹¹⁶ One effect of Coleman's sociological sophistication is, however, to point up the abiding hermeneutic naiveté of neo-classical economics. In fact, whilst it derives much of its methodology from the *Methodenstreit* of late nineteenth century German social sciences which is the principal source of interpretative social theory, neo-classical economics

¹¹⁰ Coase, 'The Nature of the Firm: Influence', p. 73.

¹¹¹ Coase, 'The Institutional Structure of Production', p. 14.

¹¹² It is, perhaps, sufficient compliment to Coase that one is simply jarred by the contrast between this *Readers' Digest* talk of galaxies and primordial matter and the carefulness about institutional detail that one identifies with his substantive work. Nevertheless, his notion that a sounder foundation for a theory of markets may be developed from 'sociobiology' has been elaborated by others, notably Becker (G.S. Becker, 'Altruism, Egoism and Genetic Fitness: Economics and Sociobiology', in Becker, *The Essence of Becker*, ch. 13). It is now being elevated into a general theory of 'evolutionary economics': e.g. J. Hirshleifer, 'Economics from a Biological Point of View' (1978) 20 *Journal of Law and Economics* 1. The notion is that even if not all behaviour is consistent with rational choice, competition and hence natural selection will ensure that those more capable of rational behaviour will survive. This elevates the naturalistic strain which has always been present in political economy into a general theory of 'biological economics'.

¹¹³ J.S. Coleman, *Foundations of Social Theory* (Cambridge, Mass.: Belknap Press, 1990). Becker's endorsement of this book in the publisher's blurb on its cover is as enthusiastic as one would expect.

¹¹⁴ G. Homans, 'Social Behaviour as Exchange' (1958) 65 *American Journal of Sociology* 597.

¹¹⁵ P.M. Blau, *Exchange and Power in Social Life* (New York, John Wiley, 1964).

¹¹⁶ The possibility of allowing a role for social norms within a law and economics framework has recently been explored in special issues on 'Social Norms, Social Meaning' (1997) ??? *Journal of Legal Studies* and 'Law and Society and Law and Economics: Common Ground, Irreconcilable Differences, New Directions' [1997] no 3 *Wisconsin Law Review*.

has never particularly bothered with assessing the adequacy of its understanding of the meaning of what it claims to be economic action,¹¹⁷ and Becker's work carries to an almost self-parodying excess a hermeneutic mistake which Weber identified nearly a century ago:

The construction of a purely rational course of action...serves the sociologist as a type (ideal type) which has the merit of clear understandability and lack of ambiguity [This is] only a methodological device. It certainly does not involve a belief in the actual predominance of rational elements in human life, for on the question of how far this predominance does or does not exist, nothing whatever has been said. That there is, however, a danger of rationalistic interpretations when they are out of place cannot be denied. All experience unfortunately confirms the existence of this danger.¹¹⁸

We would therefore urge those wishing to develop the potential of an institutionalist approach to economics, and especially law and economics, to return to its earlier roots and pick up the challenge of the 'old' institutionalists, and establish a sounder basis for economic analysis in social theory.¹¹⁹

Such an approach would seek to explain exchange, and the different social forms that it has taken historically, rather than attempting to explain the whole of human life and the history of society on the basis of a theory of exchange. Certainly, the 'new' institutionalists are able to produce much more convincing evaluations of social institutions than would otherwise be produced by work committed to neo-classical economic analysis by introducing important modifications to the assumptions underlying neo-classical economics. However, these are largely of a behavioural character. Thus, utility-maximisation is modified by expanding Coase's insight that transactions are costly into a more general acknowledgement of the 'constraints' within which exchange takes place. The main constraint is seen as that of obtaining adequate information, or perhaps more basically that imposed by limitations of time (which restricts information-gathering).¹²⁰ Some go further into the terrain of epistemology through the concept of 'bounded rationality',¹²¹ linking up with behavioural psychology. Others accept that in addition to 'environmental constraints' on behaviour, human motivation must be accepted as going beyond simple wealth-maximisation and include altruistic behaviour.¹²²

¹¹⁷ R. Boudon, 'Subjective Rationality and the Explanation of Social Behaviour', in H.A. Simon *et al*, *Economics, Bounded Rationality and the Cognitive Revolution* (Aldershot: Edward Elgar, 1992) ch. 7.

¹¹⁸ M Weber, *Economy and Society* (Berkeley: University of California Press, 1978) pp. 6-7.

¹¹⁹ Williamson has shown an interest in the 'old' institutionalists, while agreeing with a general view that the new institutional economics has had greater influence than the old precisely because it has 'shunned methodological controversy in favour of operationalisation' (O.E. Williamson, 'A Comparison of Alternative Approaches to Economic Organisation' (1990) 146 *Journal of Institutional and Theoretical Economics* 64.)

¹²⁰ Professor Goodhart himself has felt the need to underpin his own approach to monetary and financial economics, which stresses the sluggishness and inertia of markets and hence the importance of money and the role of financial intermediaries and market-makers, with a micro-economic theory which he argues should be based not on a priori assumptions but empirical study of how actual markets work in practice. This was spelled out by the addition of a new first chapter to the second edition of his text *Money, Information and Uncertainty* (London: Macmillan, 1989), which begins arrestingly 'Time is the ultimate constraint on mortals.'

¹²¹ H.A. Simon, *Administrative Behaviour* (New York: Free Press, 3rd. edn. 1976).

¹²² D.C. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge: Cambridge University Press, 1990) p. 20.

Nevertheless, the perspective is still that economic activity consists essentially of exchange. This is not only ontologically inadequate but contradicts common sense. In our view, exchange must be seen as a part of the social relations of production-reproduction which are fundamentally co-operative as well as, occasionally and in different ways, competitive or conflictual. Relations of production-reproduction are necessary for, and cannot be explained by, as they ontologically precede, exchange relationships. If economics wishes to be taken seriously as a social theory it must locate exchange in a general theory of social relations.¹²³ That there is widespread awareness of this necessity is demonstrated by the wide range of work in , or perhaps it should be said at the edges of,¹²⁴ economics which seeks to describe the ‘embeddedness’ of economic action in social structure.¹²⁵ However, though now backed up by a realist epistemology¹²⁶ which itself *is* substantially novel, the emerging ‘behavioural economics’,¹²⁷ ‘economic sociology’,¹²⁸ ‘evolutionary economics’,¹²⁹ ‘humanomics’,¹³⁰ ‘moral economics’,¹³¹ or even ‘political economy’,¹³² are merely the latest in a long line of works stressing the economic significance of ‘institutions,’ principally the law, which has always run parallel to neo-classical economics in response to its obvious lack of realism.

The last thing that can be said of work such as that of Veblen, Ayres, Commons, Mitchell, and latterly Galbraith (whose work Coase particularly disliked)¹³³, is that it reproduced the formalism of price theory. This is by no means always a positive thing. It is manifest that the work of all these figures is sometimes unclear, sometimes quite mistaken, and

¹²³ This is not merely an abstract theoretical position, but receives extensive corroboration in the historiography of what should be recognised to be the historically distinct capitalist mode of production in which exchange relationships have become the basis of social solidarity (F. Braudel, *Civilisation And Capitalism*, vol. 2 (London: Collins, 1982)). The most compelling sociological understanding of choice by rational, utility maximising individuals which is axiomatically assumed by neo-classical economics is of it as a technical rational orientation of action which has its foundations in the social relations of capitalist production (M Weber, *Economy And Society* (Berkeley: University Of California Press, 1978) ch. 2). On this capitalist basis, this orientation of action is not self-conscious, and typically has the alienated form of claiming to be (economic) action as such, that is (economic) action without historical limit (K. Marx, *Capital*, vol. 1 (Harmondsworth: Penguin Books, 1976) ch. 1, sec. 4) or restriction on the limit of its application to what really are non-economic spheres of action (K. Marx, ‘Economic and Philosophical Manuscripts of 1844’, in K. Marx and F. Engels, *Collected Works*, vol. 3 (London, Lawrence and Wishart, 1975) pp. 322-6).

¹²⁴ P. Bauer and A. Walters, ‘The State of Economics’ (1975) 18 *Journal of Law and Economics* 7.

¹²⁵ M. Granovetter, ‘Economic Action and Social Structure: A Theory of Embeddedness’ (1985) 91 *American Journal of Sociology* 481.

¹²⁶ T. Lawson, *Economics and Reality* (London: Routledge, 1997).

¹²⁷ B. Gilad *et al*, ‘From Economic Behaviour to Behavioural Economics’ (1984) 13 *Journal of Behavioural Economics* 1.

¹²⁸ R. Swedborg, ‘Economic Sociology: Past and Present’ (1986) 35 *Current Sociology* 1; R. Swedborg, ‘Major Traditions of Economic Sociology’ (1991) 17 *Annual Review of Sociology* 251 and R. Swedborg *et al*, ‘The Paradigm of Economic Sociology’, in S. Zukin and P. DiMaggio (eds.) *Structures of Capital* (Cambridge: Cambridge University Press, 1990) ch. 3.

¹²⁹ R.R. Nelson and S.G. Winter, *An Evolutionary Theory of Economic Change* (Cambridge, Mass.: Harvard University Press, 1982). Evolutionary economics of this sort, which turns on a non-naturalistic claim about an intrinsically ‘evolutionary’ quality of practical (in the technical rather than moral sense) reasoning, should be distinguished from the positivistic ‘biological’ or ‘evolutionary’ economics typically identified with Hirshleifer which we have mentioned.

¹³⁰ E. Loebel, *Humanomics* (New York: Random House, 1976).

¹³¹ A. Etzioni, *The Moral Dimension: Towards a New Economics* (New York: Free Press, 1988).

¹³² P.C. Ordeshook, ‘The Emerging Discipline of Political Economy’, in K. Alt and J. Shepsle (eds.) *Perspectives on Positive Political Economy* (Cambridge: Cambridge University Press, 1990) ch. 1.

¹³³ Coase, ‘The New Institutional Economics’ 230.

overall uneven. But it equally is the case that this unevenness is in an important respect a good thing, for it follows from a theoretical ambition which law and economics, and even new institutional economics, have not begun to match. Quite crudely in the law and economics of Posner and, in the end, quite disappointingly in the new institutional economics of Coase himself, the retention of the formalism of neo-classical economics leads to an epistemologically and ontologically unacceptable privilege being granted to exchange, and that privilege now seriously handicaps the further development of law and economics. It seems unarguable to us that this formalism must now be rejected if that development is to be continued.

In our view, such a development is indeed of great importance. Despite all its limitations,¹³⁴ Posner's work has had tremendous influence in the common law world for over twenty five years, in many respects justifiably. The central concerns of economics, the generation and distribution of material wealth, could hardly be of greater importance. In a world the vast majority of whose population still live in poverty, it is clearly imperative to apply all our intellectual resources to ensure that social institutions are designed to promote both efficiency and fairness in systems of production and arrangements for distribution. This we consider requires not merely that law and economics act as an external check on each other, but that they act within an integrated approach.

¹³⁴ J.M. Buchanan, 'Good Economics - Bad Law', (1974) 60 *Virginia Law Review* 483 and M Rothbard, 'Frank S Meyer: The Fusionist as Libertarian Manqué', in G.W. Carey (ed.) *Freedom and Virtue: The Conservative/Libertarian Debate* (Lanham: University Press of America, 1984) pp. 97-8.