LAW AND NEOCLASSICAL ECONOMICS: AN EXAMINATION OF TWO CLASSIC TEXTS AS ARTIFACTS

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In looking over the intellectual landscape of law and neoclassical economics,[1] two figures loom large as representative of both the movement and the splits within the movement. This paper explores two classic works by these figures and examines each as a historical signifier of the discipline: Ronald Coase's "The Problem of Social Cost" and Guido Calabresi's *The Costs of Accidents*.[2] In so doing, I do not wish to privilege Coase and Calabresi as the sole authorities of the law and neoclassical economics movement, but rather to examine selected pieces of their work as artifacts relevant to a larger archaeological study to be completed over time.[3] In sum, these artifacts demonstrate an orientation toward deductivism and an ideological bias against government, albeit with the latter bias contested. I must stress that these are preliminary thoughts and represent only a fragment of a fuller study I am in the process of undertaking.

I. Ronald Coase: The Beginning of a Movement

Ronald Coase's "Social Cost" is a germinal piece in the law and neoclassical economics field. It set forth both the methodological structure of the discipline and the ideological ideals which would animate much, although by no means all, of the literature to follow. "Social Cost" was a libertarian response to a strand of neoclassical economics that promoted government solutions to social problems. This libertarian bent pervades Coase's entire analysis.

Coase begins by stating that the standard economic analysis of the divergence between private and social costs had followed the prescription laid out in Pigou's

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[1]I use the term neoclassical economics to distinguish the version of economic analysis of law discussed in this comment from other economic analyses.

[2]R.H. Coase, "The Problem of Social Cost" (1960) 3 Journal of Law and Economics 1 [hereinafter "Social Cost"]; G. Calabresi, *The Costs of Accidents: Legal and Economic Analysis* (New Haven and London: Yale University Press, 1970) [hereinafter *Costs of Accidents*].

[3]For a general discussion of the concept of archaeological description as a methodology in the history of ideas, see M. Foucault, *The Archaeology of Knowledge & The Discourse on Language* (New York: Pantheon Books, 1972).

The Economics of Welfare.[4] Pigou had argued that the solution to the problem of social costs was to tax the source of the externality by the amount of costs imposed on society over-and-above private cost. The purpose of "Social Cost" was to problematize, if not discredit, this belief.

Initially, Coase had to address the metaphysics of causation. Traditionally, particularly among lawyers, it was believed that a tortfeasor had caused the harm. Coase turns this analysis on its head to make the argument that any harm "caused" is *reciprocal*. To illustrate, if a polluter is enjoined from polluting the stream running to the town, she too is harmed because she must forego the potential economic benefits from polluting. Coase saw no distinction between this harm and the cost of injury borne by a town's inhabitants. Thus, for Coase the issue is reduced to an empirical determination of whether one harm is greater than the other.

Of course, a conclusion that any inquiry into the divergence of private and social costs must be an empirical one does not in itself determine a resolution. One could argue, as did Pigou, that government (a bureaucratic agency) is in the best position to make the empirical call; however, this would be contrary to Coase's deeply ingrained libertarianism. Hence, a structure resolving the divergence of costs, but not necessarily requiring government intervention, was necessary. The core of this structure would be built around deductive argumentation.

Coase's analysis in "Social Cost" provides a clear example of the deductive methodology at the core of law and neoclassical economics. He begins by simplifying the complex relationships at the heart of Pigou's analysis of social cost in an industrial state. The problem is modelled as a dispute between two autonomous individuals: a farmer and rancher. Coase then sets out the basic background to his simplified framework: the rancher and farmer are on neighbouring properties, and as the number of cattle is increased so is the damage to crops. The central axiom which underlies Coase's analysis is that the "pricing system works smoothly".[5] In addition, and less crucial for Coase's analysis, is the initial premise that there are zero transaction costs. Flowing from these underlying assumptions are the conclusions that cost will be internalized and production maximized. In keeping with the neoclassical methodological schema, Coase, after laying out his deductive argument, moves on to provide a mathematical illustration to demonstrate the common-sense nature of the

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[4]Pigou's *The Economics of Welfare*, 4th ed. (New York: St. Martin's Press, 1962) was initially published in 1920 and was influential from its inception. See B. Seligman, *Main Currents in Modern Economics* (New Brunswick (U.S.) and London: Transition Publishers, 1990) at 477-496.

[5]"Social Costs", *supra* note 2 at 2.

bargaining process at the core of his thesis, namely, that joint production can be maximized without government intervention.

The analysis presents two relevant legal regimes: liability for crop damage and no liability for crop damage. Under the regime of liability, the rancher would not necessarily forego additional cattle production in order to avoid liability, but would add cattle as long as the liability costs were not greater than the additional value of production. Again, under the premises established by Coase, as a matter of deductive logic this is the only possible result.

Following this deductive argument, which is now commonly referred to as the "Coase Theorem", Coase draws a link between his logical-deductive system and case-law:

> The problem of straying cattle and the damaging of crops which was the subject of detailed examination in the two preceding sections, although it may have appeared to be rather a special case, is in fact but one example of a problem which arises in many different guises. To clarify the nature of my *argument* and to demonstrate its *general applicability*, I propose to illustrate it anew by reference to four *actual cases*.[6]

It is all too easy to slide over this passage without realizing its significance to Coase's thesis and, more generally, to the future development of the law and neoclassical economics movement.

While clearly articulating the premises which underlie his analysis, Coase overlooks the analytical limitations that deductive methodology necessarily entails: the conclusions reached are analytic and limited to the premises set forth in the argument and thus are not necessarily transferable to the world outside that argument.[7] Coase sets forth the facts of the cases and then superimposes on those facts his essential premise of a smoothly operating price system. He subsequently reaches the *necessary* conclusion that an efficient allocation of resources would result if the parties were free to bargain among themselves.

One example illustrates the point. The case of *Sturges* v. *Bridgman*[8] involved two confection factories which had been owned by the same company, one for twenty-six years and the other for sixty years, before a doctor came to occupy an adjoining building. The factory did not disturb the doctor for eight years. However, upon building a consulting room onto his property, the doctor discovered that the noise and vibration from the confection factories made it difficult to conduct business. The doctor was granted an injunction.

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[6]*Ibid.* at 8 [emphasis added].

[7]See W.C. Salmon, *Logic*, 3d ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1984) at 15-16.

[8](1879) 11 Ch. D. 852.

Coase suggests that the doctor and confectioner would have struck a bargain without court intervention if property rights had been established. Thus, "[t]he solution of the problem depends essentially on whether the continued use of the machinery adds more to the confectioner's income than it subtracts from the doctor's."[9] Coase goes on to state that:

> The basic conditions are *exactly* the same in this case as they were in the example of the cattle which destroyed crops. With costless market transactions, the decision of the courts concerning liability for damage would be without effect on the *allocation* of resources.[10]

Coase recognizes the inherent weakness of his premise that participants in a prospective transaction operate in a world of zero transaction costs. This is where he switches gears from the logical-deductive scientist to the institutional-inductive idealogue. He stresses that what is important is not that an assumption of zero transaction costs is in reality untenable, but rather that varying institutional arrangements necessitate different transaction costs. Thus, whether one particular institutional arrangement is superior to another in addressing the problem of social cost is a matter of empirical investigation to be resolved by "patient study of how, in practice, the market, firms, and governments handle the problem of harmful effects."[11] This would appear to acknowledge a need for *inductive* investigation as to the nature of institutional arrangements. Yet, there is no empiricism contained in Coase's piece. Instead, what is put forth is his "*belief* that economists, and policy-makers generally, have tended to over-estimate the advantages which come from governmental regulation."[12]

This interplay between scientific analysis and normative/emotive libertarian principles regarding the benefits of a free market provides an insight into the purpose of Coase's methodological argument. The deductive framework constructed by Coase is an analytical overlay which bolsters his thesis with the authority of science. This is made clear when Coase resumes his discussion of the Pigouvian tradition in the last two sections of "Social Cost".

Coase criticizes Pigou for concluding that "natural" tendencies of divergent social costs may be cured with State intervention. He offers as an illustration Pigou's example of damage done by a railroad car due to flying sparks. Coase uses the same mathematical reasoning with which he began the article to argue that allocative efficiency is unaffected whether liability is attached to the railroad activity or not. However, he adds that "[o]f course, by altering the figures, it could

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[9]"Social Cost", *supra* note 2 at 9.

[10]*Ibid.* at 10 [emphasis added].

[11]*Ibid.* at 18.

[12]*Ibid.* at 18 [emphasis added].

be shown that there are other cases in which it would be desirable that the railway should be liable for the damage it causes."[13] Thus, once again the problem is reduced to an empirical query: "Whether it is desirable or not depends on the particular circumstances."[14] Despite this acknowledgement, Coase, in surveying the influence of Pigou's thought, regrets the fact that a "doctrine as faulty as that developed by Pigou should have been so influential."[15] Nonetheless, Coase finally concedes a point he attributes to Frank Knight, an influential economic theorist: "[P]roblems of welfare economics must ultimately dissolve into a study of aesthetics and morals."[16]

II. Guido Calabresi: The Progressive Tradition

Guido Calabresi embodies the uneasy union between the American progressive legal tradition and neoclassical economics. The progressive tradition springs from his training at, and ideological ties to, the Yale Law School and is expressly acknowledged in the "special thanks" he gives to Fleming James and Friedrich Kessler in *Costs of Accidents*.[17]

It is clear at the outset of *Costs of Accidents* that Calabresi wishes to rescue the doctrinal legacy left by James and others in the pragmatic instrumentalist movement from the fate that awaits it as the burgeoning law and neoclassical economics movement begins to take shape.[18] Tellingly, he states that "there has been a realization on the part of theoretically inclined writers that the analyses that had seemed to support the trend toward nonfault liability are woefully unsophisticated."[19] Calabresi astutely notes that such phrases as "'distribute the risk' and 'let the party who benefits from the cost bear it' can no longer be accepted as sufficing to determine who ought to bear accident costs."[20]

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[13]*Ibid.* at 33-34.

[14]*Ibid.* at 34.

[15]*Ibid.* at 39.

[16]*Ibid.* at 43.

[17]*Costs of Accidents*, *supra* note 2, at ix.

[18]For a definition of "pragmatic instrumentalism" and its role in the evolution of American tort law, see J. Hackney, "The Intellectual Origins of American Strict Products Liability: A Case Study in American Pragmatic Instrumentalism" (forthcoming, *American Journal of Legal History* – manuscript on file with *U.N.B.L.J.*).

[19]*Costs of Accidents*, *supra* note 2 at 5.

[20]*Ibid.* at 5.

As does Coase, Calabresi realizes that ultimately a determination of what constitutes an appropriate legal regime must be an empirical one.[21] However, just as Coase avoids the empirical issue, Calabresi bemoans the fact that to wait for an empirical answer would doom society to the status quo. Hence, initially one must construct a theoretical framework. Although recognizing that economic analysis is not the only theoretical approach to tort law, Calabresi nonetheless asserts that "it remains a fundamental tool for analyzing problems."[22]

Calabresi begins his analysis by pointing out the potential inconsistency of the various possible goals of risk distribution. These goals include the broadest possible spreading of losses, the shifting of losses to the wealthiest, and the shifting of losses to those causing harm.[23] To decide among these risk spreading concepts, Calabresi relies upon the core of his theory: "[I]t ... [is] *axiomatic* that the principal function of accident law is to reduce the sum of the costs of accidents and the costs of avoiding accidents."[24]

In his theoretical treatment of accident avoidance, Calabresi adopts a neoclassical approach very similar to that of Coase. The problem remains the "*allocation* of resources" and the method of analysis is derived from the "branch of economics called welfare economics."[25] Calabresi recognizes that this approach assumes a basic postulate, one which he disavows elsewhere in the text: "[N]o one knows what is best for individuals better than they themselves do."[26] Implicit in this postulate are the premises that:

> [A]s long as individuals are adequately informed about the alternative and so long as the cost to society of giving them what they want is reflected in the cost to the individual, the individual can decide better than anyone else what he wants. Thus the function of the prices of various goods must be to reflect the relative costs to society of producing them, and if prices perform this function properly, the buyer will cast an informed vote in making his purchases; thus the best combination of choices available will be achieved.[27]

The logical underpinning of Calabresi's analysis conforms with that set forth by Coase: the "pricing system works smoothly."[28] This places Calabresi squarely

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[21]*Ibid.* at 13.

[22]*Ibid.* at 20, n. 3.

[23]*Ibid.* at 20-21.

[24]*Ibid.* at 26 [emphasis added].

[25]*Ibid.* at 69 [emphasis added].

[26]*Ibid.* at 69.

[27]*Ibid.* at 70.

[28]See text accompanying *supra* note 5.

within the law and neoclassical economics camp. However, there are crucial differences.

The crux of Calabresi's policy analysis lies in his articulation of the goals and subgoals of accident law: "First, it must be just or fair; second, it must reduce the costs of accidents."[29] At first glance it would seem that Calabresi's rhetorical nod toward justice and fairness sets him apart from Coase. However, in many respects, Calabresi's discussion of justice, while perhaps well meaning, is constricted given his choice to engage in neoclassical economic analysis. Moreover, while Calabresi sets up justice as a greater normative goal than economic efficiency, he nonetheless cautions: "Justice, though often talked about, is by far the harder of the two goals to analyze."[30] More specifically, statements about justice, while often appealed to, are "rarely backed up by any clear definition of what such support means, let alone by any empirical research into what is considered fair."[31]

Nevertheless, Calabresi admits that one may "readily document specific injustices that occur in existing systems, such as the fault system or workmen's compensation."[32] This is a not so obvious reference to the empirical studies done by Calabresi's pragmatic instrumentalist predecessors.[33] Calabresi also recognizes the rhetorical purpose of such studies in stating that the "requirements of fairness that those systems may meet are difficult to define and therefore are usually stated as generalities, in hope of striking a responsive chord."[34] Calabresi correctly articulates the purpose of earlier empirical studies concerning accidents,[35] and is properly concerned that this mode of analysis "may be an inadequate guide to what our reaction would be if the system were changed."[36] For Calabresi, justice may ultimately act as a "constraint that can impose a veto on systems", but its "elusiveness ... justifies delaying discussion of it."[37]

Part of Calabresi's ambivalence toward the concept of justice may be a reaction to the explicitly pro-egalitarian philosophy found in redistributionist arguments for strict products liability. Calabresi asserts that others have "sought

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[29] *Costs of Accidents*, *supra* note 2 at 24.

[30] *Ibid.*

[31] *Ibid.*

[32] *Ibid.*

[33] J. Hackney, *supra* note 18.

[34] *Costs of Accidents*, *supra* note 2 at 24-25.

[35] J. Hackney, *supra* note 18.

[36] *Costs of Accidents*, *supra* note 2 at 25.

[37] *Ibid.* at 25-26.

to use accident law as a means of reducing inequalities in income distribution."[38] However, "we usually would do far better to attack the particular problem directly rather than through accident law."[39] Despite this explicit rejection of a redistributionist project within tort law, issues of distribution are prominent in Calabresi's discussion of accident costs. This situates him as a progressive within the law and neoclassical economics movement.

In keeping with his ensconcement within the law and neoclassical economics movement, Calabresi couches his concerns about justice in the economic guise of loss spreading. However, to arrive at a policy proposal for a tort system with even mild redistributionist implications, he has to break with the fundamental tenet of the law and neoclassical economics movement: individuals are best equipped to make decisions for themselves. He does this by raising the spectre of transaction costs, which is one of the progressive law and neoclassical economics proponent's methods of arguing against the laissez-faire policies for which Coase was such a great adherent.

To summarize, this brief account of two foundational texts illustrates: (1) the deductive (anti-empirical) nature of law and neoclassical economics methodology; (2) the historical fault lines between progressives and conservatives within the discipline; and (3) the ways in which the methodology and ideology underpinning law and neoclassical economics may shape the progressive practice of the discipline. Again, these are conclusions reached by sifting through only two artifacts. This limitation notwithstanding, the microanalysis of two such foundational texts is suggestive.

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[38] *Ibid.* at 32.

[39] *Ibid.* at 32.