The Legal-economic Nexus from the Perspective of New Institutional Economists and of Original Institutional Economists

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Abstract: There are two institutional economics approaches to law and economics. New Institutional Economists prescribe that arbitrators foster efficiency in setting economic disputes, and Original Institutional Economists focus on creating reasonable values—that is, balancing efficiency and justice. Disequilibrium between desired efficiency and perceived fairness triggers agency and is a source of coevolution of law and economics.

Key words: law and economics, institutional and evolutionary economics, collective decision-making

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Herbert Liebhafsky (1987, 1811, 1819-1820, 1832) qualifies the evolutionary idea of law as a promising alternative to static conceptions of law. Scholars of the evolutionary approach in John

Commons's Original Institutional Economics tradition argue that judges should create reasonable values, and scholars of static approaches argue that judges should employ wealth maximization as an ethical imperative, foster equality of concern and respect, or restrict themselves to deductive reasoning.

Liebhafsky (1987, 1829) mentions the Coase Theorem as one of the static approaches to law and economics. I elaborate on Ronald Coase's New Institutional Economics approach in contrast to the Original Institutional Economics approach to law and economics.[1)] I argue that collective decision-making may result in harming some and benefitting other stakeholders. All stakeholders have to conform to institutional changes if they like it or not. Perceived unfairness by some and greed by others constitute a source of permanent coevolution of law and economics.

The New Institutional Economics Approach

New Institutional Economists are so to speak led by what Liebhafsky (1987, 1810-1811) qualifies a "First Principle". Namely, they restate the First Principe of the divine order to pursue "true and substantial happiness" in the instruction to maximize wealth. They say that wealth is maximized if resources are efficiently allocated. The allocation of resources is most efficient if resources are allocated in the governance structure with the lowest transaction costs. Governance structures range from markets through firms into public governance. Transaction costs are costs involved in "addressing bounded rationality and potential opportunistic behavior, that is, 'self-interest-seeking with guile'" (Spithoven 2012, 430). Public governance is assumed efficient in providing desired goods and services that are not provided by other governance structures (*Ibid*, 430, 434). Within governance structures there are differences in efficiency. Differences in efficiency induce competition. New Institutional Economists consider judges (and other arbitrators) subservient to the efficient allocation of resources in economic disputes.

The Coase Theorem

Coase argues that, if there are no transaction costs, the outcome of bargaining about reciprocal social costs is maximization of total output. Reciprocal costs are costs that inflict on damaging agents if they wish to avoid harming somebody else (Champeyrache 2013, 7). If maximizing people freely exchange well-defined property rights, then bargaining about reciprocal social costs will *not* influence the allocation of resources, *but* will redistribute income, regardless the law or regardless what judges rule (Cooter 1982, 15-16). In other words, law is neutral. The neutrality of law is an abstraction of Coase's analysis of the allocation of reciprocal social cost and has been coined the Coase Theorem (Champeyrache 2013, 2-3).

As long as transaction costs are lower than the gains of bargaining about reciprocal social costs, people may bargain a second-best efficient output. In either case, consumers' willingness to buy and producers' willingness to sell at given prices result in a Pareto optimal externality (Samuels 1991, 283).

Things change if transaction costs exceed the gains from bargaining (Coase 1960, 15-18). Then it is the decision of legislators, judges or other arbitrators that determines if the outcome is efficient or not. According to some scholars, an inefficient ruling might be avoided by applying the Coase Theorem that "suggests that the role of law is to assign entitlements to the party who values them the most so that the costly process of exchanging the entitlement is unnecessary"

(Cooter 1982, 18). The willingness to pay represents the individual utility function and is a function of distributions of income (Liebhafsky 1987, 1815-1816).

Criticisms on the New Institutional Economics Approach to Law and Economics

The judge and economist Richard Posner (2010, S33) criticizes the economist Coase for being not rigorous enough in his methodology. Coase relies on case studies rather more than on econometric analyses. Posner adopts Coase's efficiency criterion but has a more demanding approach through his belief that efficiency and, in line with this, wealth maximization is an ethical imperative and scientific concept. He defines wealth maximization as the realized consumer and producer surplus at the bargained equilibrium price (Liebhafsky 1987, 1811, 1815-1816), and Coase (1960, 5, 29) equates wealth maximization to Gross National Product.

The Coase Theorem is based on a rather optimistic view. Its scholars assume cooperative behavior and fully informed people. However, people might be badly informed about the truthfulness of provided information and consequently they may "miscalculate and fail to anticipate the moves that others will make", and noncompetitive bargains might be obstructed by lack of rules for dividing the surplus (Cooter 1982, 20). People also may decide to defect. They may decide not to bargain about reciprocal social costs but to stick to their claims. If people choose to defect, then a third party might foster efficiency by restricting "the threats which the [non-cooperating] parties can make to each other" (*Ibid*, 18-19). Regulation, Pigovian taxation (that is, taxation of negative externalities), punishment of violence against property and persons, or assigning "liability to the party whose lack of precaution is most destructive" might enhance efficiency (*Ibid*, 19). The third party intervention is coined the Hobbes Theorem. The Hobbes

Theorem ignores that bargainers may lower their demands in order to increase the probability of an agreement. Regardless of the errors, the Coase Theorem as well the Hobbes Theorem are both "illuminating falsehoods because they offer a guide to structure law in the interest of efficiency" (*Ibid*, 28).

In addition to Posner's methodological criticism and Cooter's criticism that the Coase Theorem ignores the possibility that rational people may defect, debilitations of Coase's approach are:

1) Judges cannot determine which allocation of resources is efficient because of the lack of appropriate market prices. For determining the efficient allocation of resources, judges have to refer to "prices of 'similar' goods in 'similar' situations in other places or times" (Cachanosky 2011, 68);
2) The theorem is falsified by tests of endowment effects—that is, people valuations are related to ownership. Because of loss-aversion the willingness to pay does not equal the willingness to accept (Kahneman, Knetsch and Thaler 1990), and;
3) The theorem is at odds with the assumption of Original Institutional Economists that economy and law "are jointly produced—*not* independently given, *not* merely interacting" (italics in original) (Samuels 1989, 1567).

The Original Institutional Economics Approach

Original Institutional Economists assume that individuals are socialized beings whose cooperation is enabled by institutions. Institutions not only "act to direct and define the aims and end of conduct" (Commons 1990, xx, 6) but also influence individual preferences (Veblen 1909, 629), and determine who will receive social recognition, who will get which payment, and who will have which privileges, immunities, power, freedom, liberties, duties and exposures (Samuels 1971, 444; 1973, 536). As such, institutions—among which, laws, regulations and rules—influence cooperation, distribution of income and wealth, and economic outcomes. In turn, economic outcomes influence institutions (Samuels 1971, 435). The development of institutions and economics exert mutual selective pressures through agency—that is, institutions evolves in response to a peculiarity in economics, which trait itself evolved in response to a feature of institutions that are "necessary to maintain justice and prevent infringements of the right of property" (Samuels, Johnson and Perry 2011, 196). Coevolution of institutions and economics interacts with technology and social and ethical changes (Commons 1990, 719) .2)

Economic behavior of private organizations and individuals is supposed to be a function of multiple causations which are woven together by "Scarcity, Efficiency, Futurity, the Working Rules of Collective Action, and Sovereignty" (Commons 1990, 71). Efficiency concerns rationing of production factors. Scarcity is "distinguishable as power over others" (*Ibid*, 302).[3)] Power includes "the right to exclude others and to withhold from them what they want but do not own" (*Ibid*).[4)] An unequal distribution of power to withhold supply and to acquire the goods and services one want, market manipulation, and leverage of market power might generate outcomes, such as monopolistic profits or wages that are perceived as unjust or unreasonable. *Ergo*, competition on efficiency may end in various distributive results (Cooter and Ulen 2012, 110; Samuels 1991, 283-284). Not all necessarily generate sustainable economic growth, "full and steady employment" (Commons 1990, 805), healthcare for those who need it most, and a society without systemic fraud (Spithoven 2017a, 690). Competition on efficiency may result in an allocation of resources that, next to life threatening pollution, puts the chronically poor at risk of premature death" (Samuels, Johnson and Perry 2011, 250, 265).

Adjudicators are assumed, first, to assess the fairness of prices, salaries, interests, remunerations, and profits, and, second, to rule on their reasonableness. Unfair distributions that are generated in bargaining and managerial transactions might be addressed by public rationing. Rationing concerns judicial decisions, logrolling, dictatorship and all associations for control of output, cooperation, collective bargaining, and taxation. All affect income and wealth distribution, and purchasing power (Uni 2017, ix, 3, 15, 19-20).

The role of governments

According to the Original Institutional Economists in the tradition of Commons, governments are entitled to make "fundamental decisions about the socioeconomic order" (Samuels 1973, 535) and to develop institutions accordingly. By contrast, Thorstein Veblen (1978, 284-285) mistrusts governments to settle public goals. Veblen qualifies governments as vehicles of the ruling class. Namely, vested interests may influence lawmakers by personally informing legislators, by financially supporting their campaigns, or by executing specific media campaigns (Brown 2013, 215, 217; Veblen 1978, 285-286). As such, they indirectly influence institutions. Veblen's skepticism is an inducement to stay critical to the guiding role of governments.

Additionally, it might be argued that there is the danger that the judiciary becomes another political institute. Namely, the United States Constitution does not include an economic theory concerning the governance of the economy. Judges have to rely on their ideological antecedents at their rulings in cases concerning highly ideologically contested economic issues in Congress. In order to avoid an infringement of the rule of law, the judiciary should be reluctant to grant review to plaintiffs concerning ideologically contested issues, and legislators and executives should abstain from commenting on pending lawsuits or from filing briefs (Spithoven 2017b).

From the perspective of Veblen-Ayres-Foster's instrumental value paradigm, social goals "*cannot* be found in the subjective mindset of individuals [. . .] but are instead to be [scientifically] investigated through" (italics in original) (Ramstad 1989, 762, 766). However, this is not without problems. Social scientists are biased as well. The contesting briefs in Obamacare lawsuits indicate this. A group of economists, amongst others the Nobel Laureates Kenneth Arrow, George Akerlof, Eric Maskin, and Peter Diamond, filed briefs that supported the 2010 health care reform, and other economists, amongst others the Nobel Laureates Vernon Smit and Edward Prescott, filed briefs that opposed the reform. The variety of schools in economics "represents a social reality that ought to be taken into account when various interests and instrumental theories are constructed" (Nancy Brenner-Golomb 2011, personal communication).

Theory of Reasonable Values

Commons's (1990, 4, 715-716) "participation in collective action, in drafting bills and" the associated study of rulings of the Supreme Court of the United States resulted in a common-law notion of reasonable value. Courts approach precedents by a method of "exclusion or inclusion." Courts and other arbitrators have to assess if bargaining, managerial, and rationing transactions meet the criteria of reasonableness—that is, if they meet precedents or current working rules (custom, precedent, statute, by-law, constitution and habitual assumptions) (Commons 1990, 704).

They must consider the power of transaction partners and establish if the contracting partners are adequately informed.

According to Commons (1990, 763), the creation of reasonable "value is not intellectual or rational—it is the the valuations of stupidity, passion and ignorance, and the dominant collective action that controls individual action . . . In any case the dominant institutions decide by collective action what is reasonable, regardless what individuals think."

Adjudicators built reasonable values on a due weighing of "future effects of present acts" (*Ibid*, 826) and of all interests. Reasonableness is a matter of justice and judgment (*Ibid*)—that is, weighing relevant facts, opinions and experiences of experts and representatives of commoners and the privileged—that is, vested interests (Commons and Andrews 1967, 443). Consequently, reasonable values do not constitute absolute entities but historic data (Commons 1990, 682). They "are artificial, collective, transitory, forfeitable" (*Ibid,* 703) and reflect the social and economic goals governments aims to realize—that is, *inter alia*, what type of society one aspires to actualize (Vatn 2005, 160). In essence, they balance desired efficiency and fair distribution (Commons 1990, 682). If macroeconomic issues are involved, reasonableness of laws and regulations is, to begin with, subject to the authority of democratic institutions. In the United States of America, laws are also subject to constitutional review.

Governments consist of a formally separated legislative, executive and judicial power. Legislators and executives have the responsibility to govern and a duty to act which implies the will to find compromises between different wings of parties or between parties. They have an answerable composite decision-making right. Judges have an answerable authoritative decision-making power and with their interpretation of laws and regulations they say what the laws and regulations are (Solo 1974, 37). Consequently, judges are in a material sense also involved in lawmaking.

Legislators, executives, and judges might be ideologically biased. Nevertheless, the method of creating reasonable values might offer a reasonable path to go. People may balance efficiency and notions of a fair distribution of income through discourse and communication. People cannot achieve it solitary (Heyes 2017, 8). A reasonable distribution might imply, *inter alia*, "equality of treatment in matters of taxation" (Commons 1990, 651-652). Governments also may differentiate towards sources of income (labor, wealth, capital) and choose for progressive or digressive taxation. Its reasonableness is influenced by the judgment of future effects (*Ibid*, 696).

Collective decision-making

Arbitrators create reasonable values through reasonable practices or working rules, *inter alia*, the custom of recognition of the authority of courts and preceding judicial rulings or decisions (Commons 1990, 704, 742), aggregation, position, boundary, payoff and information rules (Spithoven 2017c). Working rules "govern the distribution of power, *and* the distribution and exercise of power govern the development of the working rules" (italics in the original) (Samuels 1973, 536). The type of working rule influences to whom priority is given (Spithoven 2017c). For example, given that rulings in court are decided by majority voting, a highly ideologically contested law filed in Congress by Democrats is more likely to be upheld in the Supreme Court of the United States with a 5-to-4 Republican majority than with a 6-to-3 Republican majority. At a 5-to-4 majority, only one (modest) Republican judge has to shift votes. Consequently, not only working rules but also the personalities on the bench of decision boards such as the Supreme Court determine the creation of reasonable values (Commons 1990, 684).[5)] Therefore, the direction of socio-economic development is not pre-determined (Gellner 1988, 3) but may change its path with a change in ideological color of Congresses or ideological background of judges (Spithoven 2017c).

In order to settle a reasonable solution by majority rule or otherwise, consulting all who is involved in a conflict may heighten cooperation and trust. Eventually, everybody "must conform under similar circumstances" to decisions by adjudicators (Commons 1990, 683) regardless if they like it or not. It might be either a source of a new conflict even if decision boards unanimously decide for a change or a force to re-identify oneself (Spithoven 2017c). Namely, not all stakeholders who are represented by the contesting decision-makers have to support the decision wholeheartedly.

Conclusion and Discussion Notes

According to New Institutional Economists, bargaining about reciprocal social costs result in an efficient outcome as long as benefits are higher than the transaction costs. However, if transaction costs are higher than benefits, then law matters, and lawmakers and judges should aim to minimize transaction costs. Because the available reference prices are disequilibrium prices, intervention by judges resemble income distribution mechanisms.

Conversely, Original Institutional Economists approach law and economy as a function of each other. The price mechanism may foster efficiency but not necessarily result in a fair income distribution. Fairness may require the creation of reasonable values. The essence of reasonable values is to find a balance between efficiency and a fair distribution of income. It requires balancing interests—*inter alia*, through consulting all stakeholders—and an assessment and interpretation of laws and their applications. However, collective decision-making might be ideologically biased and institutional changes harm some and benefit other stakeholders. Absolutely or relatively deprived stakeholders may perceive the outcome being unfair, and benefitting stakeholders may think that the change lags far behind what is desired to enforce efficiency. The persistence of disequilibrium between desired efficiency and fair distribution of income (and wealth) may result in coevolution of law and economics.

Endnotes

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1) The difference between the New Institutional Economics approach and the Original Institutional Economics approach has some points of similarity with the division between the Chicago school and the Yale school of law and economics. The Chicago approach places neo-classical oriented economics at the center of the analysis of law, and the Yale approach proclaims that law shapes our values, and, consequently, that economics may benefit from law (Calabresi 2016). Each of these approaches is richer and more nuanced than can be dealt with in this article. I have to skip several complexities and subtleties.

2) Commons distinguishes technology and institutions, and others include technology in the definition of institutions (Waller 1982, 762). Commons places "the technological function in managerial transactions" (Atkinson and Reed 1990, 1098).

3) Agents are legally considered equal in bargaining transactions. However, if they are economically unequal, then scarcity might be addressed by coercion. If they are economically equal, then scarcity is addressed by persuasion (Commons 1990, 64).

   This statement should be nuanced. In addition, countervailing powers lobby successfully (Spithoven 2016).

4) The inverse of selling power is purchasing power (Commons 1990, 128)—that is, the power to acquire that what one want but does not own.

5) Also new cases that present old assumptions in a new light and changes in economic or political conditions influence Supreme courts' opinions (Commons, 1990, 699).

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