

# THE ROLE OF THE CHICAGO SCHOOL OF ECONOMICS IN THE GENESIS OF A NEW FIELD OF RESEARCH: *THE ECONOMIC ANALYSIS OF LAW*

Ramona CIOBANU<sup>1</sup>

**Abstract:** *The interdisciplinary approach adopted nowadays, in terms of law and economics, is closely linked to the Chicago School of Economics. This has made a great contribution to the development of economic science and to lawyers it has a special significance because within it the Law and Economics school of thought or Economic Analysis of Law was created. The economic analysis of law uses terms, concepts and economic institutions that apply to different areas of law and it is meant to improve the legal norm.*

**Key words:** *economics, law, the economic analysis of law.*

## 1. Introduction

There is a link between law and economics and this has been known since antiquity. How to study exchange, rent, interest, wages, without talking about property, contract, obligation? Economists and lawyers meet on the same ground, but each with a different perspective: predicting needs - the economist - and exercise of rights - for law practitioners [1].

The Interdisciplinary approach performed nowadays from the perspective of law and economics, is closely linked to the Chicago School of Economics. The areas of interest for the economists of this school are very different, for example the concern for price and currency, with its chief representative Milton Friedman, the founder of monetary trends; the study of efficiency with its representatives Gary Becker, Jakob

Mincer, Ronald Coase, who are the creators of the *new microeconomics*; the concern for economic development and international trade, with such representatives as Harry Johnson and Peter Bener.

Although adherents of this school are characterized by disagreements on many specific issues, there are some ideas that define and particularize this current of thought. The Chicago economists are the advocates of an economy based on private property, free enterprise and competition. In the first half of the twentieth century, they were less concerned than other economists, with the social and economic implications of monopoly and oligopoly, arguing that economic activity must be conducted according to the principle of classical liberalism, *laissez faire, laissez passer*.

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<sup>1</sup> Faculty of Law, *Transilvania* University of Braşov.

Moreover, early members of the Chicago School such as Frank Knight and Henry Simons were concerned with the connection between law and economics, opposing the monopoly of social control through regulation, but recommending public ownership in certain economic sectors and the establishment of natural monopolies, such as the railways and top industries. This was the dominant view of the Chicago School in the period 1930-1940, during which the legal regulation of economic activity was widely employed in the United States.

The promotion of this opinion was intended to curb excessive state interference in economic life. The Concept of the Chicago School underwent a drastic change in the years 1950-1960 when Stigler, Friedman, Coase and other economists reassessed the economic effects of the regulation and proposed new solutions.

According to economist Milton Friedman, the conditions that give rise to technical monopoly are changing rapidly and public regulation and public monopoly are less sensitive to these changes than private monopoly. The view that private monopoly is higher than the public one is associated to the economist Harold Demsetz, the main promoter of competitive actions who presented their advantages and argued for the conclusion of contracts with the state.

The Government might grant a permit or an operating license to the highest bidder, one who makes the offer to serve consumers at the lowest price. Competition between bidders for a permit or license pushes their earnings down to a level imposed by the competitive market.

In terms of microeconomics, the representatives of the Chicago School are trying to demonstrate the relevance of a theory of individual choice in which sovereign consumers are able to conduct a

maximized behavior. The Research of the School of Chicago is based on the theoretical work of Frank Knight's as economist and social philosopher.

According to Knight, individuals are free to use the means at their disposal to achieve their goals, every transaction being a choice between alternatives. In other words, choices are governed by *the principle of opportunity cost*. His economic theory and method prove his commitment to the dictum as social philosopher: *to live like a human means to have the ability to choose*, arguing that the goal of the economist is to reach a scientific body of truths with the premise of individual freedom of choice.

Economic freedom was essential to Knight, since it is the basis of all other forms of freedom: political, intellectual, religious. A Perfect Market is, in Knight's view, the embodiment of complete freedom, maximizing human behavior so as to manifest fully in this market. Knight supported the principle of *laissez faire*, but ignored the need for legal provisions to prevent intolerable deviations from free market conditions.

Moreover, the specificity of the Chicago School is to support efficient competitive market economy and to highlight the danger posed by excessive concentration of economic and political power.

Chicago economists have promoted a new area of research - Law and Economics - as a basic interdisciplinary field of social sciences. They brought in the research of economist problems that have traditionally been regarded as hovering outside the scope of economics.

Thus, they analyzed the relationship between allocative efficiency and ownership. The article became a classic of Ronald Coase, *The Problem of Social Cost*, directed this interdisciplinary effort, and the journal *The Journal of Law and Economics*, published at the University of

Chicago, provides a forum of research emanated from Coase's article.

Given the importance of Coase's work for the emergence and evolution of the Law and Economics field of study, we present here what is known as the Coase Theorem economic theory.

Externalities – are phenomena that can affect the market's ability to efficiently allocate resources – they have been permanently in the attention of economists.

They occur when an economic activity generates costs (or revenues) of another undertaking, for which the latter is not compensated (or not paid). Externalities or, in other words, external costs and benefits affect production and consumption.

Any company that produces goods uses not only goods they buy or rent at market prices, but also goods for which it pays nothing, but whose costs are covered by others. Coase notes that courts are often called upon to determine compensation for what economists call *externalities*. Court findings have implications for the economic concept of factors of production. Coase tried to give a definition of this concept, pointing out that, typically, it is thought of as a physical entity which the businessman acquires and uses (1 hectare of land, a ton of fertilizer) instead of a right to take physical action.

We can consider the earth and the right to use it a factor of production, but in fact what the owner of land has is the right to be entitled to undertake a well-defined list of actions. The land owner's right is not unlimited [2]. For example, some people may have the right to cross his/her land (servitude of passage). In his article, Coase refers to ownership, the dismemberments of ownership, the easements, other legal institutions.

If inputs are regarded as property rights, the cost of the exercise of a right by one person - that of using a factor of

production - is another person's loss caused by exercise.

For example, the right to make other people, for example, unable to cross an area of land to build a house, to enjoy a view, to take some quiet time to breathe fresh air. In other words, when property rights are assigned the reciprocal waiver is required. This mutual relationship explains how the parties engaged in conflict can resolve their differences without outside intervention. It is what economists call *internalization of externalities*.

Internalization of externalities may occur through consensual agreement between the parties or by operation of law which regulates the relations between the parties in question. For example, if A causes injury to B, then B can bribe A to induce him to alter his work, but if B has a legally enforceable right enshrined opposed to A, then A will have to pay B to support the results of his work.

The Coase Theorem states that economic efficiency will be achieved if property rights are fully allocated. Parties are able to negotiate property rights, putting resources into position with maximum efficiency.

Thus, if in a building with several owners, one of them opened a customer store, the flow of people would disturb the others. The latter would be able to bribe or tease the first to close shop as they could claim a sum of money for its operation.

Both arrangements would lead to the same result: the store would operate only when the neighbors' inconvenience is optimal. Coase's theorem is based on rational negotiation by both parties considered capable of leading to economic efficiency.

But Coase admits that the market has its limits because transaction costs for solving different problems can be prohibitively high.

Recourse to market can be costly: knowing the market price level can be a problem, plus the cost of entering and

executing the transaction. In these situations, the state - through law - should make the decision to allocate resources efficiently and has the role, through the court, to determine that the interests of the parties prevail in order to have the greatest value on the market. Coase and generally the Chicago School of Economics give courts the power to make the right decision based on the principle of opportunity cost.

The views held by economists in Chicago triggered inevitable criticism. Thus, the Chicago School was accused of tending to blur the distinction between real and ideal market, represented by perfect competition, and that the differences between real and ideal market are much more significant than they appreciate.

Another concern of critics would be that modern economists argue in favour of the Chicago School's approach that it is the market's ability to restrict monopoly without state intervention in regulating it. Critics are skeptical of this idea. Also, while the Chicago economists argue in favour of the virtues of competitive markets, critics point out that it produced large inequalities in income distribution, reflecting the failure of free competition.

Despite criticism, the Chicago School has made a great contribution to the development of economic science and it has a special significance to the law practitioners since it was formed within the *Law and Economics* school of thought or the *economic analysis of law*. Law and Economics, Economic Theory of Law or Economic Analysis of Law are the names used in specialty literature. In the 70s we can recount a multitude of works, for example, Richard Posner, *Economic Analysis Of Law* (1972); Arthur A. Leff, *Economic Analysis Of Law: Some Realism About Nominalism* (1974) [3].

Initially, the attention of economists was directed only towards several areas of law,

especially towards the market, competition, monopoly, regulation of public services, so economic theory identified itself with the content of antitrust law. Over time, the area has expanded due to interdisciplinary concerns, addressing economics and other areas of law.

We have to mention the work on contracts done by Robert Hale, Henry Simons 's research on taxes, the works of Henry Manne regarding corporations, of Arnold Plant regarding licensing, of Bentham on offense and sanctions. However, even after the emergence to *The Journal of Law and Economics* in 1958 from Chicago, The Law and Economics movement has been associated primarily with problems of competition and monopoly.

Until 1960, when Ronald Coase published the article *The Problem of Social Cost*, and Guido Calabresi published his first article on torts we could not talk about a solid economic theory in its own right. After this, in a few years, the economic analysis of contracts emerged, property rights, consumer protection, criminal law and it began to outline a mature field called the economic analysis of law.

Later, studies and articles have been extended to other areas such as labor law, intellectual property law, family law, environmental protection and the list goes on.

The economic analysis of law expanded to such an extent that the dean of Yale Law, a critic of the field, said in 1995 that the law and economics movement is a force in American law and that he thought the case law in this country is influenced by it [4].

One of the most important representatives of contemporary economic theory of law, Richard Posner, judge and professor at the Faculty of Law, University of Chicago, although a lawyer by

profession and not an economist, conducted for over 30 years, careful, rigorous and relevant economic analyses in many areas of law.

This eminent exponent of the Law and Economics movement, known and quoted in the USA and Europe, says that the economic analysis of law is twofold: to make the law simpler, more easily understood and evaluated and to help us defend our values. The economic analysis of law is not an ivory tower, an intellectual abstraction, but it is firmly anchored in reality that it explains and models, using two instruments: law and economics.

We can ascertain by reading the recommended literature [5], two aspects of this interdisciplinary effort.

On the one hand, the economic analysis of law encompasses interpretive and descriptive aspects, trying to explain and predict the behavior of persons. On the other hand, it includes a standard of trying to improve laws, by emphasizing the negative consequences of provisions such as low economic efficiency or uneven redistribution of income.

The economic analysis of law uses terms, concepts and economic institutions that apply to different areas of law. This analysis is undertaken in order to make legal provision allowing the study of how the rule of law shapes the behavior of individuals and the degree of achievement of objectives.

Given the practical connotations carried by the promoters of the theoretical economic theory of law, this movement was imposed and managed to influence the U.S. legislative reform in several important areas, such as antitrust laws (with which he started the economic analysis), public services, environmental protection, the calculation of damages in workplace accidents, securities market, ownership, investments, including those made from the pension fund. *The Law and Economics*

*Movement has been an important factor in the development of free market ideology.*

The impact that this movement has had on American society in general and the academic and justice fields in particular is demonstrated by the fact that many law professors also have, in addition to their specialization, a MASTERS degree in economics, law schools employed teachers with a Ph.D. in economics, there are magazines devoted to economic analysis and research in the field of law, judicial decisions using economic concepts that cite books, articles, economics studies.

Many judges, including U.S. Supreme Court judges are experts and promoters of the Law and Economics movement, recognizing the important contribution to the development of legal thinking.

The work of economic analysis of the law did not go unnoticed in Europe. Gradually, its importance has been recognized for shaping law, the Law and Economics movement gaining followers on the old continent, both among economists and lawyers. Papers were published, the economic analysis of law began to be studied at European universities in masters programmes and even doctoral studies are performed in this interdisciplinary area. We mustn't forget the *European Master in Law and Economics* (2004-2008, 2008-2013), a conglomerate of nine partner Universities across Europe and the world, Aix-de-Provence (France), Bologna (Italy), Ghent (Belgium), Haifa (Israel), Hamburg (Germany), Mumbai (India), Rotterdam (Netherlands), Wien (Austria) and Warsaw (Poland), in cooperation with the *Law and Economics Center* of the Berkeley University, California. The Programme has been recognized by the *European University Association* as the top ten Socrates program and was selected by the *European Commission* as the *Erasmus Mundus Masters Course*. Also the

*European Association of Law and Economics* has been established in 1984.

In conclusion, we can say that the seed planted by economists in Chicago grew, rose and even paid off, experts pointing out that the role of economic analysis in moral, political or legal disputes is to draw attention to the consequences or implications that people without economic knowledge are tempted to overlook.

Economists struggle to make us aware of the consequences of actions and facts that we would otherwise consider merely good or bad.

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