LAW AND ECONOMICS: THEORETICAL PUFFERY, EXAGGERATED CLAIMS AND COUNTERFACTUAL MODELS

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Abstract: Economic analyses of law predominate in the United States because they can claim to be objective and scientific thus verifiable and the basis of predictions and reproducible experiments. However, several of the claims of economic analysis of law go too far and are entirely unrealistic. This explains why economic analysis of law has not been taken up outside of the U.S. to the extent it has in the U.S. This article points out the unrealistic presumptions within law and economics theory (homo economicus and efficient markets, mostly) and the unrealistic claims of law and economics (that the law is and should be a mirror of the economy). Economic analysis of law cannot and should not serve as a general basis of legal decision making. However, as a special theory applicable as a method for determining certain issues, economic methods can well inform legal decision making helping judges to shape justice correctly. This article exposes the competing schools within law and economics and presents a defensible version of economic methodology applied within legal discourse.

I. INTRODUCTION

Economic theories of law are relevant in the very least to budgetary and tax policies. Though law is not -and should not be- a mirror of the market, there are places where economic methods of analysis can be useful for judges, for examples when balancing competing interests, when determining objective monetary values. A comprehensive theory of law and justice cannot ignore economic theories of law, particularly because economic theories of law currently dominate American legal theory, with a corresponding global influence, and this since at least 1980.

There are several competing schools of thought within law and economics. This article will outline their differences and try to draw out the differing implications they have for legal interpretation. I will especially try to point out the weakness of the various theories in order to make clear their limits.

There are real methodological and prescriptive differences within the various schools of law and economics. However, they share at the broadest level a similar outlook and method: liberal individualism and distrust or outright hostility toward the state. At a narrower, but less defensible level they also share a model of homo economicus (the rational profit maximizer) and/or of efficient markets and/or a model of perfect information (cost-free, instantaneous, global information flow, facts known or at least knowable to all), though the more specific these propositions become the greater the divergences within the various schools of law and economics become evident. The differences among the schools will be exposed both to show the development of this complex of thought and to show the possibilities and limits of economic analyses of law.

The position I take is that some methods of economic analysis, such as cost-benefit analysis and economic evaluation of balancing tests, can be usefully applied to law.[1] Economic valuation of competing interests to be balanced renders tractable otherwise indeterminate legal decisional methods such as "interest balancing" by making the weighing of competing interests at least explicit, if not objective.

However, while there clearly is a place for economic models of valuation, there are also definite and serious flaws in the strongest assertions of the law and economics school of thought. Purely economic analysis of law does not in fact adequately describe or predict legal decision making because economic analysis of law is founded on invalid presumptions about the nature of the market.

Because of the limits of economic analysis of law arising out of unrealistic presumptions about the nature of markets and market participants, economic theories of law have only met mixed reception outside the U.S. and other common law countries, and rightly so. General theories attempt to describe all cases of a given phenomenon and even to provide insights into phenomena peripheral to their object of focus. Special theories limit themselves to a subset of one field and do not claim any general applicability beyond their object of focus. General theories seek to be universal, whereas special theories are limited and particular. Economic methods of analysis can have a valid application to legal decision making as a special theory confined to particular cases. However, economic theories of law are not valid descriptors for a general theory of legal decision making. Thus, in the end, law and economics, like most efforts at a general systems theory of the last century (e.g., Einstein:

[1] E.g., Judge Learned Hand's Test finds a duty in tort where the cost to prevent an injury would be less than or equal to cost to cure the injury Richard Posner, Economic Analysis of Law, Boston: Little Brown (1977) p. 5.

general theory of relativity; Keynes: general theory of employment, interest and money; Kelsen, General theory of law and the State), collapses from a grandiose failed effort at a unified theory with universal validity back into a special theory with valid application only in specific instances and not generally.

The economic theories of law split from each other to varying extents because of splits between classical and neo-classical economic theories. These are outlined below. Essentially, I hope by explaining those theories and their flaws in detail to help the reader understand both what are sound budgetary, tax and monetary policies (telos for legal interpretation and application) and also to understand the practical possibilities and limits of methods of economic analysis in law generally. Economic analyses of law can be useful but are no panacea to the problems of interpreting and applying laws.

II. THE HISTORICAL ORIGINS OF CONTEMPORARY L&E IN CLASSICAL ECONOMISTS

A. Adam Smith

Adam Smith illustrates well how an aggregation (induction) of multiple individual data points can result in the attainment of a complete aggregate that is, the interplay between atomism and holism. Smith only implicitly treats methodological issues concerning holism and atomism in The Wealth of Nations. In general, his thinking appears to be atomistic: society is broken down into individual elements (i.e. individuals) who buy the goods needed to attain their individual well-being as they see fit. Their motivation is purely selfish. However, the sum total of their individual self centred decisions results, according to Smith, in the best possible social situation. For Smith, the aggregation of individual self interest results in the attainment of the best collective interest. In his example of the daily market - where the brewer and the baker attain their own well-being by offering those goods necessary to meet the needs their customers[2] - we see a perfect example of atomism. From this point of view, the collective does not exist, only its components. Yet, out of that individual interest a best possible collective interest results.

[2] WN: B.I, Ch.2, Of the Principle which gives Occasion to the Division of Labour in paragraph I.2.2

Smith also presents an example of the famous pin factory.[3] Here, he shows that cooperation and specialization of workers allow 10 people to collectively produce 48000 pins a day – even though in isolation these same people could not produce that 20 each.[4] From an apparently atomistic position Smith has induced collectivist conclusions. Smith discovered that specialization increases productivity. That discovery is problematic for atomism and demonstrates why holism is the more accurate theory. Smith has identified that specialization of individuals in the collective is more productive than individual artisanal production.

B. David Ricardo

Ricardo affirms and deepens the point that specialization through trade results in peace and prosperity.[5] Trade leads to interdependence and prosperity and thus makes war less likely.[6] Ricardo's main contribution was proving that free trade is good for both parties *even where one party has an absolute advantage in all goods traded* so long as a relative advantage remains between at least one of the traded types of goods.[7] Together, Smith and Ricardo form the common backbone of liberal trade and economic theory.

III. LAW AND ECONOMICS: RICHARD POSNER

The equivalence of economic and political theory, the idea of a school of political-economy, finds its roots in English in Ricardo. In contrast, the conflation of law and economics is a newer phenomenon. The leading advocate of law and economics is Judge Richard Posner.

Posner offers a purely economic analysis of law. He is one of the representatives of pragmatic materialistic thinking which is fairly widespread in the English speaking world. As such he is not an "anarcho-capitalist"[8] - he is statist. Starting from unrealistic neo-classical assumptions – that economic

3 WN: B.I, Ch.1, Of the Division of Labour in paragraph I.1.3
4 Ibid.
5 David Ricardo, On the Principles of Political Economy and Taxation 7.13-7.16 (John Murray 1817),available at http://www.econlib.org/library/Ricardo/ricP2a.html#Ch.7,%20On%20Foreign% 20Trade
6 James Buchanan and Yong Yen, *The Return to Increasing Returns*, Boston: University of Massachusetts Press. (1994) p. 331.
7 Ricardo, at 7.13-7.16.
8 Richard Posner, The Economics of Justice (Cambridge, Mass: Harvard University Press, 1981) p.119.

actors are rational profit maximizers[9] operating under conditions of perfect information,[10] Posner argues for even less tenable conclusions. Posner argues that the common law is developed based on its ability to maximize social wealth.[11] According to Posner, law seeks to maximize economic well-being of citizens.[12] Alone, that would not in itself be a problematic assertion. However, Posner goes on to argue further that the law mirrors,[13] and should mirror, economic processes.[14] Those views are not tenable. Essentially, the legal theory proposed by Posner can be summed up as law being swallowed whole by economics.

My first criticism of Posner is methodological. His theory - that law is developed to maximize wealth - must ultimately define and measure this wealth. But measuring the economy with precision is a very difficult task (the greater the precision the greater the difficulty). Furthermore, money is not the only indicator of individual or social well-being. Posner however bases his theory on economic market values and so his theory is one dimensional. All goods cannot be monetized. For example, air cannot realistically be bought or sold yet is vital. Likewise a scenic view from one's own property onto another's cannot be bought or sold – the legal issue of "spite fences" exemplifies the problem.

My second criticism of Posner is also methodological. His method is reductionist.[15] If we adopt his position then legal decisions become a question of economic interests, only. But that view would completely ignore teleology, hermeneutics, and exegesis when interpreting legal texts. Interest balancing – whether using abstract vague and manipulable "utilities" or concrete economic values does not consider exegetical and teleological interpretations of law which escape yet can shape marketplace evaluation. Further, Posner's method

[9] Richard Posner, Economic Analysis of Law, Boston: Little Brown (1977) p. 1.

[10] *Ibid.* p. 5. - "a free market operating without significant externality, monopoly, or information problems."

[11] *Ibid.,* p. 4 - "the common law is best explained as if the judges were trying to maximize economic welfare."

[12] Richard Posner, Overcoming Law, Cambridge: HUP (1995) p. 109.

[13] Posner, above n 9, p.5

[14] "The hypothesis is not that the judges can or do duplicate the results of competitive markers, but that within the limits set by the costs of administering the legal system (costs that must be taken into account in any effort to promote efficiency through legal rules), common law adjudication brings the economic system closer to the results that would be produced by effective competition - a free market operating without significant externality, monopoly, or information problems." Richard Posner, Economic Analysis of Law, Boston: Little Brown (1977) p. 4-5

[15]*Lloyd's Introduction to Jurisprudence*, Lloyd and Freeman (eds.), Lloyd's Introduction to Jurisprudence, (5th Edition) London: Steven and Sons (1985) page 431.

doesn't provide reasons why society does or whether society should in fact maximize wealth. Moreover, he begs the questions of: maximize wealth *for whom*? and *why*?

My last critique of Posner deepens the methodological weaknesses that we have just discussed. Posner's method confounds and confuses justice and wealth[16] and overemphasizes economic factors in legal decision making. His troubling equivalence between justice and wealth confuses wealth and morality.[17] He thinks that markets are "efficient" - but efficient for whom? For those who hold wealth of course. Making the wealthy wealthier may be a good thing but the point is this goal is simply assumed and goes unquestioned in Posner's purely market driven universe.

Axiological cognitivism enables us to criticize the assimilation of morality to market values; Posner is confusing cause and effect, as well as means and end. Law and economics shape each other as superstructural justification and rationalization (law) of a material base of productive forces (economics). They are in a mutual feedback situation which is generally determined by the economy. Aristotle makes clear that, as concerns distributive (social) justice, the economic system (the principle of distribution) is positive and conventional – it is determined by the laws of man, not those of nature. That is, the economic framework (communism, socialism, capitalism, feudalism etc.) is selected by the legal system. In contrast, for Posner, the economic system is and should be strictly determinative of the legal system. Posner also confuses the means (wealth - goods) and the end (a satisfying life - the good). Moreover, Posner hasn't accounted for Marx's views on the relation between productive base and ideological justificatory superstructure. Posner also doesn't take into account the views of Aristotle on distributive (social) justice and commutative justice (justice in transactions; corrective justice) – he focuses all his energy on justice in transactions, i.e. commutative justice. Thus, he champions a reductionist theory which can only partly explain the phenomena of the relation between economic forces of production and juridical relations about production. Determining whether and where Posner is atomist or holist could improve the quality of Posner's contribution to legal science as would meeting these criticisms.

To conclude, Posner suffers from a sort of reductionist thinking. He overemphasizes the market. In the end, Posner's theory is yet another example

[16] *Id.* at 431.

[17] Richard Posner, *The Economics of Justice*, 1983 in *Id.* at 526 - "I have tried to develop a moral theory that goes beyond classical utilitarianism and holds that the criterion for judging whether acts and institutions are just or good is whether they maximize the wealth of society."

of a crisis in Anglo-Saxon thought resulting from a poorly integrated theoretical atomism and fixation on empiricist methodology, the inability to see a forest where there are trees. That view is incomplete, even from the liberal individualist economic point of view: The value of a community is - according to capitalists like Smith (specialization),[18] Ricardo[19], (trade) Aristotle (humans are a rational, social, talking, animal), and Hayek (money as resource allocation signal) - more than the value of its members due to synergies such as specialization[20] and economies of scale. But this is contrary to the atomist ontology characteristic of Anglo-Saxon thought. That contradiction leads to theoretical confusion in the case of Posner. Law can and should give all members of a society the means to the end of a good life. Part of the good life consists in adequate wealth to live decently. However, Posner does not seem to see Aristotle's position, that wealth is a means to the end of the good life and not an end in itself. The good life is made possible by wealth - but wealth, though a necessary means is not sufficient to attain the end of the good life.[21]

IV. THE CHICAGO SCHOOL (SUPPLY SIDE THEORY): MILTON FRIEDMAN

Supply side theory is a reaction to the failures of Keynesian theory and essentially antithetical to Keynesianism. Supply side thinking dominated the American scene between 1980 and 1992 and remains very powerful and influential. This theory of the Chicago school can be summarized as an affirmation of the market and a radical critique of state intervention.

A. Supply determines demand

Supply side theory suggests that the balance between supply and demand is determined by supply - unlike Keynes; supply in this perspective creates its own demand. In fact, for supply side theory, supply disequilibria are relevant

18 Smith also presents the famous example of a pin factory. He shows that cooperation and specialization of workers allow 10 people to collectively produce 48000 pins a day – even though in isolation these same people could barely produce 20 pins each. WN: B.I, Ch.1, Of the Division of Labour in paragraph I.1.3

19 Ricardo takes and deepens Smith's view in his analysis of comparative advantage in international trade. Ricardo stresses the consequences of a policy of free trade: that free trade results in more wealth even for countries which are relatively inferior in all terms of trade. David Ricardo, *On the Principles of Political Economy and Taxation*, Ch.7, On Foreign Trade para. 7.16 http://www.econlib.org/library/Ricardo/ricP.html

20 Adam Smith, *Wealth of Nations*, B.I, Ch.1, Of the Division of Labour in paragraph I.1.3

21 See, Plato, *Republic*. Aristotle, *Politics*.

only in the specific case of a crisis - and even then, monetary policy can prevent and correct the imbalances. The supply side view is correct because the information economy constantly creates new consumer goods which are not basic necessities yet which are at times capital goods and also greatly improved and continues to improve coordination of supply and demand for traditional products. Thus, supply side theory holds true, at least in the IT branch. Greatly improved coordination of demand and supply brought about by instant global communication explains the constant decrease in inventory stocks during the last thirty years. "Just in time trade" strongly confirms the supply side theory shows how improving the flow of information augments productive capacity.

B. The General Theory as a special theory

According to Milton Friedman, Keynesian theory is partially incorrect. For Friedman, Keynes's theory in fact is focussed on one particular case - a major crisis - and is not valid as a general theory.[22] That can be seen from the stagflationary failure of Keynesian theory in the 1970s. Friedman rightly criticises the Keynesian proposition that a rise in employment can result from an increase in the supply of money[23] – true in the short term, but false in the mid and long term. Hayek and Friedman are very similar in their rejection of the Phillips curve.[24]

C. Primacy of the Market

1. The role of prices

The Chicago school argues that:
1) Economic behaviour can be best explained by the neoclassical theory of prices.
2) The competitive market is the best form of economic organization.
3) Hence, the state must refrain from any significant change in the allocation of resources.[25]

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[22] Milton Friedman, *John Maynard Keynes*, *available at* http://www.geocities.com/ecocorner/intelarea/mf1.html

[23] *Id.*

[24] Milton Friedman, *Monetarist Economics*, Oxford: Institute of Economic Affairs, (1991) p. 67; Milton Friedman, *La Monnaie et ses Pieges*, Paris: Dunod (1993). P 249-261.

[25] Maurice Baslé et alia, *Histoire des pensées économiques - les contemporains*. Paris: Editions Sirrey (1988) page 307.

The market is regarded as the best regulator and more effective than the state because prices play the role of signals that make economic calculation rational and optimally allocate resources by avoiding waste. Money is seen as a quantum of information:[26] Prices transmit information, they encourage resource users to be guided by this information,[27] and they encourage owners of these resources to take account of this information.[28]

2. Monetary Policy

Supply side theory is defined then by the key role given to supply as determining aggregate equilibria, as creating its own demand. Supply side theory also defines itself by its positions on taxation, monetary policy and fiscal policy. As a tax theory, supply side theory suggests that taxation does not acting on a static economy – rather, the economy reacts to any taxation. Thus, an increase in tax does not necessarily mean a transfer of wealth or increase in state revenues. Taxes can encourage or discourage the wealth creation - which is the condition of its previous distribution. Supply side theory emphasises production of wealth and points out the risks that are inherent to a redistributive tax policy (which is not equivalent to a *fiscal* policy of redistribution). What are its positions on monetary and fiscal policy? To understand this should appreciate that supply side economics is also a theory of currency.

a. Money as a signalling system

26 F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

27 M. Bruce Johnson, *Hayek and Markets*, 23 SW. U. L. REV. 547, 548 (1994) ("Hayek argued that markets coordinate the various bits of information and knowledge scattered among individuals spontaneously, without design or comprehension by any human mind."). This might seem to be what Adam Smith said. However, Smith focuses on self love as the driving economic force reasoning inductively. For Hayek, in contrast, the driving economic force is information. Thus, Hayek would reject the labour theory of value. Money to Hayek is just information. Smith, like Locke and Marx, argues that money is but crystallized labour (the labour theory of value). For Hayek, money is reified. It may represent labour, in its origin, but in its ends it is more than just labour. It is labour applied to projects. Hayek thinks this is best coordinated by decentralized market transactions. Money, for Hayek, has both a past (the labour it represents) and a future (the investments it will fund) and is also a signal (a quantum of information). This is why Hayek does not, in my opinion, reject the labour theory of value. His theory of money and trade, in my opinion, goes beyond what Smith, Locke and Marx were saying.

28 *Prix et Théorie économique*, M. Friedman. Paris: Economica, 1983.

According to Friedman, the role of money in the capitalist economy[29] is to set standards of production, to organize production,[30] and to channel and coordinate production.[31] Currency serves to maintain and increase the productive apparatus and adjusts short term consumption to production. Currency is used as a signal in the economy. Thus, distortions of that signal are very bad. For this reason, Friedman proposes an anti-inflationary monetary policy.[32] Inflation is bad for the economy, a 'disease'[33] because it is distortionary. The cause of this disease is bad monetary policy.[34]

b. Money as an instrument of economic management

But currency plays a second role, because it is also a good.[35] It is both use value and exchange value. The price of money is measured in its interest rates.[36] It has both a stable demand[37] and is inelastic[38] -- according to Keynes demand for currency is elastic.[39] An increase in the amount of money (an increase of M1) will have the effect of triggering inflation,[40] but ultimately will not have an effect on reducing unemployment.[41] According to Milton Friedman, a change in the price of money – that is, a change in interest rates - to address the exogenous shocks is valid as a solution to unemployment only under conditions of a deep general crisis such as in 1929.[42]

c. Monetary policy must prevent inflation (and deflation)

Due to the fact that the market for money is not neutral,[43] that money is both a means by which other goods are exchanged and itself a good, inflation (as

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29 Milton Friedman, *La Monnaie et ses Pieges*, Paris: Dunod (1993). P 9.
30 Id.
31 Milton Friedman, *Capitalism and Freedom*. Chicago: U.Chi. Press (1962)
32 Milton Friedman, *The Optimum Quantity of Money*, Chicago: Aldine Publishing (1970). p 1.
33 Milton Friedman, *La Monnaie et ses Pieges*, Paris: Dunod (1993). P 191.
34 "Inflation is always and everywhere a monetary phenomenon". *Milton Friedman, Monetarist Economics*, Oxford: Institute of Economic Affairs, (1991) p. 16.
35 Milton Friedman, *The Optimum Quantity of Money*, Chicago: Aldine Publishing (1970). p 52.
36 *Ibid.* p 51.
37 *Ibid.* p 62.
38 *Ibid.* p 143.
39 *Ibid.* p 142.
40 *Ibid.* p 95.
41 *Ibid.* p 96; p. 106.
42 *Ibid.* p 107.
43 Milton Friedman, *Monetarist Economics*, Oxford: Institute of Economic Affairs, (1991) p. 15.

well as deflation) is by nature bad for the economy.[44] For this reason budgets must be balanced.[45] And, if inflation must be controlled, the mechanisms to attain stable growth with minimal cyclical downturn
are monetary and fiscal policy, not regulation of prices[46] or wild printing of fiat currency (M1). Moreover, monetary and fiscal policy is linked[47] because an inflationary policy will have an effect of being a hidden tax.[48] In other words, distortionary market interventions, such as controls on wages and prices, are unproductive.[49] Governmental economic interventions cannot create a stable level of full employment.[50] Fortunately, effective remedies for the disease of inflation exist: indexing prices and interest rates to take into account inflation, and fiscal discipline.[51]

Inflation cannot be used effectively to address unemployment and in fact even increases unemployment according to Milton Friedman. Thus Friedman – like Marx – believes in a natural rate of unemployment.[52] As to exchange rates, they must be freed from artificial regulatory standards and determined by the free market.[53] Thus the collapse of the Bretton Woods system was not inherently problematic according to supply side economics.

d. Opposition to state intervention

The logical consequence of a preference for markets is an opposition to state intervention. However the Chicago school does not argue for anarchism, it too is statist. Opposition to State intervention is however reflected in supply side monetary theory: The creation of currency[54] and the manipulation of interest rates[55] alone cannot stimulate[56] economic growth.[57] The exactitude of these

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[44] *Ibid.* p 265.
[45] *Ibid.* p 264.
[46] *Ibid.* p 264.
[47] Milton Friedman, *Monetarist Economics*, Oxford: Institute of Economic Affairs, (1991) p. 11.
[48] *Ibid.* p. 25.
[49] Friedman, *The Optimum Quantity of Money*, p 264. "Monetary and fiscal measures are the only appropriate means of controlling inflation."
[50] *Ibid.* p 117.
[51] Milton Friedman, *Monetarist Economics*, Oxford: Institute of Economic Affairs, (1991) p. 30.
[52] Milton Friedman, *La Monnaie et ses Pieges*, Paris: Dunod (1993). p 261.
[53] Friedman, The Optimum Quantity of Money, p 157.
[54] Maurice Baslé et alia, *Histoire des pensées économiques - les contemporains*. Paris: Editions Sirrey (1988).Page 314 - 315.
[55] C. Lévy, Inflation et Systèmes monétaires, 1969.
[56] "La politique monétaire est une action structurelle et non un réglage conjoncturel." Maurice Baslé et alia, *Histoire des pensées économiques - les contemporains*. Paris: Editions Sirrey (1988).Page 309.

findings is verified by the experience of the 70s. The controls on wages and prices then only encouraged inflation and unemployment by causing distortions in the price structure which reduced the effectiveness of the system. The resulting decrease in production increases the adverse side effects of the fight against inflation rather than reducing them. Controls on prices and wages waste manpower.[58]

The manipulation of money supply - or the interest rate - does not lead to increased employment. This is not to say that there is no role for the state in the economy. Under the condition of a non-inflationary monetary policy and a balanced budget the state can allocate, lend or borrow in order to make effective collective economic policies. Thus, fiscal policy is a better tool for state intervention than monetary policy. Monetary policy is "defensive" assuring stability, a condition precedent for prosperity. Fiscal policy in contrast is "active" and allows effective State interventions.[59]

V. THE VIENNA SCHOOL

Contemporary Anglo-Saxon legal thinking is dominated by echoes of the theorists of the Scottish enlightenment in social contract thinking (Hobbes, Locke) and in economic theories of law (Smith, Ricardo). However, within economic thinking about law, the Austrian school of economics attempts, unsuccessfully, to present alternatives to the intellectual progeny of the Scottish enlightenment. Although the Vienna circle started in the 1920s in Vienna, most Vienna circle theorists went into exile during the Second World War. After the war most intellectuals remained in exile settling in the USA - including Kelsen, and Hayek; further, most of the Vienna circle's post war publications were in English.

The Vienna Circle is defined around an attempt to create a new epistemology. Vienna epistemology denies the existence of ideal and metaphysical entities, so it is consistent with modernity (materialism) and expresses the same atomism and scepticism that we have already seen since William of Occam.

The Vienna circle is essentially hostile to government because of atomism and radical individualism, a tendency reinforced by the experiences of

57 Maurice Baslé et alia, *Histoire des pensées économiques - les contemporains*. Paris: Editions Sirrey (1988).Page 311 - 312.

58 M. Friedman, *La Liberté du Choix*, Paris: Belfond 1980.

59 Maurice Baslé et alia, *Histoire des pensées économiques - les contemporains*. Paris: editions sirrey - Page 317 - (1988).

totalitarianism during the second war. The Vienna circle's attempts to build an innovative epistemology – whether by considering entities only in their relationship with each other and not in terms of themselves, or by an attempt at deconstruction of thought, or by a rejection of the empirical were ultimately abandoned as too obscure and ultimately failed to serve as the basis for a way of thinking independent of the modernity from which it issued.

Thus, Mises and Rothbard are marginalized because of their radical subjectivist epistemology, whereas Hayek moved to prominence because he abandoned his attempt to adopt or apply Vienna circle methodology to neoclassical theory. The Austrian school's attempt to break from the epistemology of late modernity via a radical constructivism and its consequence, a pure theory, failed as seen most clearly in the irrelevance of Kelsen. The need for theory to be grounded in the praxis, in the real world of every day life (Marx) explain the empirical failure of the Austrian school's economic theories and Hayek's choice to abandon the more radical positions of the School of Vienna.[60]

Whatever the differences within the theory of law and economics between the school of Chicago, Virginia, and Vienna, their proposals on the practical level are similar. Theorists of the Vienna school are against any state intervention in the economy. They presuppose that economic choices are sound and are done in the framework of free competition. They oppose state economic planning and collective action because, in their view, these acts impede the flow of information, increase transaction costs and hinder individuals[61] from achieving all they can. They believe everyone is motivated by profit.[62] In other words, the presuppositions of the differing schools of economic thought are sufficiently similar allow them to be analyzed under one rubric, law and economics.

The economic wing of the Austrian School includes anarcho-capitalists such as Rothbard and Mises but also statists like Hayek. The Vienna school also includes Freud, Jung, and Kelsen who, though opposing state power, do not seem to be anarchists. The anarchism wing of the Vienna school must be qualified as but a partial anarchism - which brings to mind Nozick, underscoring our position that the similarities among the schools of Virginia and Chicago on the one side and the school Vienna on the other are greater than the differences.

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[60] Hayek ultimately criticized Kelsen's epistemology. Friedrich Hayek. *Droit Legislation et Liberté*, vol. 2. PUF (1976) page 57 because Kelsen isolated theory from practice making verficiation impossible and thus rendering theory useless.

[61] Maurice Baslé et alia, *Histoire des pensées économiques - les contemporains*. Paris: Editions Sirrey (1988).Page 283.

[62] *Id.* at 295.

A. Mises and Rothbard

Sometimes Rothbard is characterized as an anarcho-capitalist because he proposes the replacement of the State by a total privatization of public functions.[63] Roth bard's is very hostile toward the State. He regards the state as an armed gang of criminals[64] and rejects the state as legitimate form of social organization.[65] Yet David Friedman, who is also an anarchist, is not in the Vienna school for methodological reasons - his economics are neoclassical.

Should the Austrian school be regarded as a serious alternative to neoclassical thought?[66]

The Austrian school offers a subjectivist methodology and a constructivist epistemology. Classical economic theory is in contrast objective. Subjectivism condemns the Vienna school to powerlessness, isolated from practical experience, as clearly illustrated in the case of Kelsen's pure theory of law. Subjectivism leads to a rejection of statistical reliability. The epistemology of the Vienna School is materialist, but it cannot be verified by material experiences due to subjectivism. Thus, Viennese positions are purely formal. Statistical methods, rejected by the Vienna school, are a prerequisite for a verifiable study of the past and also for predictions. The ability to predict is abandoned by the Austrian theory.[67] The Austrian school, despite its rejection of epistemological realism, should be seen as purely formal representation – and thus, this is doomed to sterility.

Rothbard and Mises also reject certain presuppositions of neoclassical economics; in particular that agents are rational economic actors,[68] that human needs have no limits, but also the ability to objectively measure market values. Their methodology is unique as it is a priori and non-empirical.[69] This method cannot verify propositions and so must be rejected -- it cannot propose pragmatic solutions to real problems. Starting from their rejection of the neo-

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63 Peter Marshall, *Demanding the Impossible: A History of Anarchism*, Chapter 36, available at: http://dwardmac.pitzer.edu/dward/newrightanarchocap.html

64 *Ibid.*.

65 *Ibid.*

66 Schmidt, David Versailles, *Une théorie hayekienne de la connaissance économique?*, Revue d'Economie Politique N° 6, XI/1999 Paris: Dalloz. p. 822.

67 *Ibid.*

68 Bryan Caplan, *The Austrian Search for Realistic Foundations* *http:*www.gmu.edu/departments/economics/bcaplan/ausfin2.doc

69 Xavier Greff (ed.) *Economie*, Paris: Economica, 1990. p. 16.

classical approach, the Vienna school tries to develop a new methodology,[70] without success.[71] In the end a rejection of a statistical methodology[72]` dooms the Vienna circle to irrelevance.[73] The most striking example of irrelevance and impotence is Kelsen – who, incidentally, is strongly criticized by Hayek.

B. Hayek

Hayek's positions are prudent and reasonable, in part because of the fact that Hayek breaks with the positions of other issues Austrians. Hayek, who opposes the totalitarian state, had no objection to the State itself and can not be considered an anarchist.

1. Hayek on inflation

Hayek's position on inflation is quite clear: inflation, at the macro-economic level, especially over time, is disastrous for the economy. The experience of Germany between 1923 and 1930 is empirical evidence of this. The American inflation between 1973 and 1981 - which triggered hyperinflation, for example in Argentina and Israel - are other examples of what is now orthodoxy: that inflation distorts economic signals. A neutral monetary policy - zero inflation - encourages productivity.[74]

2. Hayek on epistemology

Hayek's epistemology is noteworthy:[75] Sometimes his epistemology brings him closer to the other theorists of the School of Austria; usually it far surpasses them by its brilliance.

For Hayek the question of the economy is in fact a question of information.[76] The problem of economic science is to develop a heuristic to manage

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[70] Bryan Caplan, *supra The Austrian Search for Realistic Foundations*, http:// www.gmu.edu/departments/economics/bcaplan/ausfin2.doc
[71] *Ibid.*
[72] *Ibid.*
[73] *Ibid.*
[74] Friedrich von Hayek, *Money, Capital, and Fluctuations*, London: Routledge, (1984). p. 161
[75] Bryan Caplan, *The Austrian Search for Realistic Foundations*, http:// www.gmu.edu/departments/economics/bcaplan/ausfin2.doc
[76] Friedrich Hayek, *Economics and Knowledge*; Presidential address delivered before the London Economic Club; November 10 1936; Reprinted from Economica IV (new ser., 1937), 33-54.

information disseminated and known only partially.[77] In other words, the information economy is far from perfect - which condemns both socialism (a planned economy is impossible due to complexity) - and the theory of efficient capital markets. The Chicago school's efficient theory capital markets hypothesis proposes that markets function perfectly and thus information flow is also perfect (instantaneous, global, with no transaction costs). Hayek sees however that in reality information flow is imperfect, that there are always transaction costs (e.g., translators, lawyers) and communication is neither cost-free nor instantaneous. His perception of the limits to information explains both the need for minimal regulation but also the impossibility of an effective planned economy. Hayek's epistemology will have further implications, and must be examined in depth yet to identify them. We begin with a deepening of Hayek's theory on information, i.e. his epistemology.

According to Hayek:
* There is a vast amount of information -- it is impossible for any one agent to know all information.
* Information known by a company is greater than the information held by any individual person.
* There is little difference between the absolute difference of a well-informed person and an ill-informed person (This is a questionable proposition – Warren Buffet would disagree with it).
- However, the relative difference between the knowledge of an ill-informed and well-informed person is crucial to economic acts. Despite the fact both are ill informed relative to any company and the market as a whole the better informed person can outperform the less well informed person)

These epistemological points explain in detail why a planned economy or an anarchic state are less productive than an unplanned economy in a State. A planned economy cannot manage all the information available and will produce too much or too little. But an entirely anarchic economy will be unable to efficiently distribute information and face heightened transaction costs: for example in an anarchist system transaction costs will be raised by the need to employ private agencies for security and other similar conflicts will reduce the availability of information. It seems that Hayek has managed to achieve Aristotle's golden mean, literally, in the field of economics.

Hayek's epistemology allows him to surpass other Austrians, and lead him to the following conclusion:

[77] Friedrich Hayek, *The Use of Knowledge in Society,* Reprinted from the American Economic Review, XXXV, No. 4; September, 1945, 519-30.

* The formation of consciousness operates at a level below the conceptual[78] level and not at the symbolic level.

Rather than compare our sensory perceptions with our concepts (whether innate – materialism - or learned - behavioralism), our perception is triggered by the object. If that object is quite distinct, (sensory impression > threshold of perception) it is conceptualized as an object our conscience. The objects of understanding, from this perspective, are built for and by us. This form of constructivism is not subjective but ultimately denies the opportunity of verification – some objects will exist but not be cognized as such due to being below the requisite perceptual threshold. This radical subjectivity brings Hayek epistemologically closer to Rothbard and Mises, but was ultimately abandoned by Hayek in practice for the simple reason that its consequence is the erasure of knowledge and its replacement by subjectivity. I reject the Vienna school on constructivism because truth exists outside the observer as an objective fact.

Despite the criticism of Vienna style constructivism, Hayek's theory influences theories of artificial intelligence especially in cognitive science and it is radically different from a materialist conception (where the object of perception will have a real existence apart from the observer, for example Marx), or idealistic (where the object of observation is in fact an instance of a noetic emanation, e.g. Plato). Hayek's epistemology is consistent with one of the final positions of the School of Vienna: that knowledge is subjective, and created by the observer (which is not my position).

The aporia raised by this theory is that the epistemology of the subjectivist Vienna circle,[79] which also refers to values,[80] is contradictory to a nomothetic economic theory. Thus, Vienna economic propositions, if consistent with Vienna school epistemology, must be purely formal. For this reason a consistent Vienna economics cannot have a practical application - which makes the Vienna school powerless in practice. This impotence is more

78 Barry Smith, The Connectionist Mind: A Study of Hayekian Psychology, in S. F. Frowen (ed.), Hayek: Economist and Social Philosopher: A Critical Retrospect, London: Macmillan, 1997, 9-29 available at: http://cogprints.org/306/0/connect.html&ei=u3RtSeCBHYzAMcriregM&usg=AFQjCNF9Wtwr9Lfmj1oqfyQ9pL99P3qbuQ

79 Carlo Zappia, *Radical Subjectivism and Austrian Economics* in Mongiovi G. and Koppl R. (eds.), *Subjectivism and Economic Analysis*. London: Routledge (1998).

80 According to Hayek costs are subjective and incommensurable. Hayek, "Economics and Knowledge", *LSE Essays on Cost* James Buchanan, G. Thirlby (eds.) New York: NYU Press (1981) pp 14-15.

evident in Rothbard and Mises than Hayek, obviously. However, it should be remembered that Hayek essentially broke from the Vienna school as outlined above.

In summary, for Hayek, information is unevenly distributed and only partially known.[81] That is to say: there is a plenitude of information, but this vast "ocean" of information is known only partially by any economic agent - including a government. He is correct there. An obvious implication of that fact is that transaction costs exist, and are inevitable. Another is a healthy scepticism toward universalist proposals. Hayek rejected planned economies because of the fact that information available to the planner will be too limited to meet the needs of consumers.[82] But he also rejected the Chicago theory of the efficient capital market because that theory proposes that information is perfect and that regulation of capital markets is ineffective which isn't the case.

Verifying Hayek's epistemology directly is difficult if not impossible. Our verification is indirect and consists of a determining the correspondence between his economic model and the empirical reality. Hayek's position on inflation[83] is exact. The empirical verification comes from historical experiences, notably in Germany in the 1930s. The verification shows Hayek's theory is correct. Rectitude here is defined as a correspondence between reality and a description developed from reality. Hayek's descriptive conclusions are correct: the difficulty is that they are based on an epistemology which appears, in a theoretical sense, contradictory.[84] This contradiction - which we believe is only apparent – arises because of the fact that the epistemology of the School of Vienna is subjective.[85] But this contradiction is only apparent. Hayek does not insist that Austrian economics is fundamentally different from neoclassical economics. Thus he can use statistical methods and other tools of neoclassical economic analysis. He could also explain this contradiction by using the distinction between practical reason (phronesis) and theoretical reason. Hayek's epistemology will then be theoretical rationality, but his economic thinking will be practical reason (phronesis). By way of either of these two loopholes the theoretical contradiction in Hayek's work disappears.

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81 Schmidt, David Versailles, *Une théorie hayekienne de la connaissance économique?* Revue de'Economie Politique N° 6, XI/1999 Paris: Dalloz. p. 819.
82 *Id.* at 820.
83 Friedrich A. Hayek, Can We Still Avoid Inflation? in *Austrian Theory of the Trade Cycle and Other Essays* (1978).
84 Friedrich von Hayek, *Money, Capital, and Fluctuations*, London: Routledge, (1984). p. 184.
85 Christian Schmidt, David Versailles, *Une théorie hayekienne de la connaissance économique*, Revue de'Economie Politique N° 6, XI/1999 Paris: Dalloz. p. 822.

3. Hayek's Prescriptions

As to his prescriptions, Hayek, like other neoclassical theorists, advocates privatizing certain state functions.[86] Yet, Hayek reserves a role for the state to provide essential goods.[87] In contrast to other neoclassical economic theorists, Hayek appears to be holist – he recognizes that human society is more powerful than one man alone. Hayek notes that freedom and equality are concepts in tension and even opposed. He proposes privatization of the monetary function of the State. Of the neoclassical theorists his thinking is definitely the most interesting and is likely influenced by Schumpeter.

VI. THE SCHOOL OF PUBLIC CHOICE: JAMES BUCHANAN

Is there a democratic path to move from individual preference to a rational collective choice where citizens are not victims of external pressures, such that everyone is free to make choices?[88] The School of public choice tries to find (affirmative) answers to this question. Public Choice aims to apply the tools of economic analysis to policy issues. Thus, one can speak of a "political marketplace"[89] of "electoral prices", "fiscal prices"[90] and "fiscal markets."[91] In this market, one can distinguish supply (a policy) and demand (the vote of citizens or their representatives).[92]

Public choice is based on three fundamental assumptions. First, only property rights can best ensure the rights of individuals in the framework of the market.[93] Second, the existence of market failures in resource allocation does not justify government intervention, except in a very few cases. That is why it is necessary to allow individuals to establish "quasi-markets" that could lead to an optimal situation. Third and finally, according to Public Choice, the market is the real factor of stability in "social systems".[94] Are these views valid?

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[86] F. von Hayek, "Toward a Free Market Monetary System" *Journal of Libertarian Studies*, 1979 p. 1.

[87] Friedrich Hayek, *The Constitution of Liberty*, and *Anarcho-Capitalists* in *The Constitution of Liberty*, Chicago: University of Chicago Press, (1960).

[88] Maurice Baslé et alia, *Histoire des pensées économiques - les contemporains*. Paris: Editions Sirrey (1988). Page 139.

[89] *Ibid.* at 137.

[90] *Ibid.* at 226.

[91] *Ibid.* at 225.

[92] Jean-Claude Martinez, *Lettre Ouverte aux Contribuables*, Paris: Albin Michel (1985). P. 37.

[93] James Buchanan *Post Socialist Political Economy*, Cheltenham, UK: Edward Elgar (1997).

[94] Poussard Dany Écotaxe: La fiscalité comme instrument de politique publique, entre incitation et efficacité, Mémoire du DEA, Université Paris I (1995). Page 30.

A. The analysis of "political markets"[95]

Public choice is a neoclassical individualistic theory.[96] It can be compared to Posner's theory of law and economic because it establishes equivalence between the economic and the political. However, it differs from Posner in that it does not create an analogy between justice and economy. Instead, it makes an analogy of politics and the marketplace.

Buchanan proposes an anarchical individualist theory[97] based on the social contract directed[98] to an anarchic individualist utopia.[99] However, Buchanan admits the social contract model is unrealistic.[100] Buchanan justifies this contradiction, by arguing that the social contract is 'just a simplified model'.[101] Buchanan recognizes the fact that man is a necessarily social animal[102] - in spite of the individualism he advocates. He takes up the atomist model conscious of the alternative organic and holist model.[103] Buchanan adopts a clear atomist perspective while also considering the possibility of a holistic model which he nevertheless rejects. He does not prove his atomism, rather he sees the choice of atomism or holism as an indemonstrable postulate.

He proposes then to study policy phenomena with an analysis based on an analogy between the market[104] and the "public choice".[105] Taxes are similar to the purchase price of services and public goods.[106] In this perspective, the government is akin to a household: it must develop its own financial policy based solely on its resources.[107] If one considers the fact that resources are limited and needs endless – the model of homo economicus - the government faces a dilemma: by asking voters whether to increase spending, the latter will always respond in the affirmative.[108] On the other hand, whenever the government asks the voters whether to raise taxes, voters will always adopt a negative response. Buchanan's position is simply that these two issues of

95 James Buchanan *Les Limites de la Liberté*, Paris: LITEC (1975) p. 178-184.
96 James Buchanan and Gordon Tullock, *The Calculus of Consent.* Ann Arbor: U of M Press. (1965) p. 297.
97 James Buchanan, *Les Limites de la liberté*, Litec (1992) p. 63.
98 Buchanan, *The Calculus of Consent.* p. 318., Buchanan, Les *Limites de la Liberté*, p. 41.
99 *Ibid.* p. 3.
100 Buchanan, *The Calculus of Consent.*, p. 318.
101 *Ibid.* p. 318.
102 James Buchanan Les Limites de la Liberté, Paris: LITEC (1975) p. 1.
103 James Buchanan, *Public Principles of Public Debt.* Richard Irwin: Illinois (1958) p. 152.
104 James Buchanan, *Public Finance in Democratic Process.* Chapel Hill: UNC (1967). p. 113.
105 Buchanan, *The Calculus of Consent.*, p. 323.
106 Buchanan, *Public Finance in Democratic Process.* (1967).
107 *Ibid.* p. 131.
108 *Ibid.* p. 97.

employment and taxation should be considered simultaneously. [109] Public choice offers the public a principle of resource allocation[110] to avoid otherwise inevitable fiscal illusions[111] such as retention at source of income tax.[112]

Regarding procurement policies, Buchanan proposes that the legislation is tantamount to a property purchased - directly or in the form of donations, contracts, etc. However, this proved to be a rather ambiguous position that indirectly condones corruption - which seems paradoxical. We see here the problem the (supposed) equivalence made between economics and law. If pressure groups use their economic power to make tacit or implied contracts, crooked or otherwise, with voting representatives and essentially buy legislation how can one distinguish what is legitimate from what is not? In all events, public choice admits that the markets do sometimes fail, including political failure, but argues that political processes also fail and are not necessarily any better or worse than market processes and can in fact be modelled in market terms.

1. Political failure

From the economic analysis of politics, public school finds failures in public institutions analogous to those encountered in private institutions.[113] Thus, the inevitable problems of externalities,[114] monopolies and transaction costs - resulting from the imperfections[115] of information[116] - must also be considered in the "political marketplace".[117] Public choice rightly questions whether and how the state can be neutral and if not what that implies for legitimacy of the state. However, public choice does not question the existence of externalities - unlike the Austrian School - because political markets also suffer from externalities!

[109] *Ibid.* p. 97.
[110] *Ibid.* p. 72-73.
[111] *Ibid.* p. 97.
[112] *Ibid.* p. 139.
[113] Birgir Runolfsson Solvason, Ordered Anarchy, State, and Rent-Seeking: *The Icelandic Commonwealth 930-1262,* http://www3.hi.is/~bthru/contents.html
[114] Buchanan, *The Calculus of Consent.* (1965) p. 45.
[115] Basle, *Histoire des pensées économiques*, vol. II, "Les Contemporains". Paris: Sirrey (1988). p. 364.
[116] *Ibid.* p. 182.
[117] Birgir Runolfsson Solvason, Ordered Anarchy, State, and Rent-Seeking: *The Icelandic Commonwealth 930-1262,* http://www3.hi.is/~bthru/contents.html

2. Bureaucracy

Public choice argues that the government's main customers are in fact lobbyists[118] and bureaucracy who seek after their own interests.[119] Thus, public choice is consistent with supply side theory. Although the School of Vienna and public choice are both opposed to state intervention - and support its privatisation - their presuppositions are different.

3. Public bads

The School of public choice affirms the existence of externalities and imperfect trade because of transaction costs[120] and because money influences the political processes.[121] Public choice affirms the existence of externalities and that trade is imperfect due to transaction costs.[122] Public goods do exist, according to public choice, and they are defined by the characteristic of their collective benefit[123] (impossibility to exclude). Thus, public goods such as the administration of justice, defence, coining currency and minting money are legitimate functions of government.[124] That is why we believe - despite his criticism of the state - that Buchanan does not reject ultimately the state itself - unlike the anarcho-capitalists.

4. The Political Market

If the political market, populated by the homo politico-economicus, [125] is a market like any other, with its own law of supply and demand the instrument to bring the supply and demand curves into equilibrium is money and the vote.[126] Thus the vote is one of the key for comprehending economic cycles.

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118 Buchanan, The Calculus of Consent. (1965) p. 283.

119 Source: A. Silem, Encyclopédie Économique et de la Gestion. Paris: Hachette (1991) Page 372.

120 David Friedman "The Political Marketplace", Public Choice: Economic Analysis of the Political Market, Sec. V, Ch. 19.

121 *Ibid.*

122 Basle, *Histoire des pensées économiques*, vol. II, "Les Contemporains". Paris: Sirrey (1988). p. 366.

123 James Buchanan *The Public Finances*, Homewood Illinois: Richard Irwin (1960) p. 539.

124 *Ibid.* p. 19-21

125 James Buchanan and Gordon Tullock, *The Calculus of Consent.* Ann Arbor: U of M Press. (1965) p. 23.

126 David Friedman, "The Political Marketplace", *Public Choice: Economic Analysis of the Political Market,* Sec. V. Chapter 19.

Voting cycles and economic cycles are 180 degrees out of phase according to public choice because representatives try to schedule their re-election at economic peaks or economic peaks at the time of re-election.[127]

Given the political influence on the economy the school of public choice asks if political influence is neutral. Public choice admits the existence of market failures.[128] At the same time, it asks whether the political market also has failures[129] and answers in the affirmative.

B. Consequences of the analysis

1. Balanced Budget

Given the trend of electorates to want public services without paying corresponding taxes there is a definite tendency towards debt financing by government.[130] However, budgetary imbalance encourages inflation; balanced budgets discourages inflation.[131] A balanced budget allows stability for economic business planning.[132] This is the tension in budget policy which should have implications for prudent legal interpretations of tax and budgetary laws. Ultimately, public school choice advocates fiscal responsibility[133] - one of the pillars of the new economic orthodoxy. Inflation in effect operates as a hidden tax pushing taxpayers upward into higher tax brackets.[134] Thus balanced budgets and zero inflation are desirable economic goals.

2. Privatization of legal functions

The school of public choice concludes from applying economic methods to political phenomena that that efficiency goals are generally better served by a privatization of public functions and budget transparency. Their logic is:
1. States are at least as flawed as markets as allocation mechanisms.

127A. Silem, *Encyclopédie Économique et de la Gestion*. Paris: Hachette (1991) Page 373.
128Basle, *L'Histoire des Pensées Economiques*. Vol. II: Les Contemporains. Paris, Sirrey (1988) p. 364.
129*Ibid*.) p. 365.
130James Buchanan, *The Public Finances*, Homewood Illinois: Richard Irwin (1960) p. 121.
131 *Ibid*. p. 88.
132 *Ibid*. p. 122.
133 *Ibid*. p. 139.
134 *Ibid*. p. 359.

2. Public goods do not exist, or if they do, non-public goods are at least as well distributed by markets as by the state.
Since public goods are rare to non-existent and since states are no better at allocation than markets then why should one rely on the state as an allocation mechanism?[135] Thus, privatization and non-intervention is the implicit conclusion from public choice theory. This is not in contradiction to libertarian anti-statist policies.

C. Critiques of the School of public choice

Within its own terms, public choice is coherent. However, I critique the school public choice on three points:[136] 1) I reject utilitarianism because utility, divorced from money, is not objectively able to be measured. 2) I question certain presuppositions of neoclassical theory taken up by public choice. 3) The theory of public choice is anti-democratic.[137]

1. Public choice is a utilitarian theory. However, the Vienna school is correct on utilitarianism:[138] The incommensurability of utilities - because of their subjectivity - indicates that utilitarian analysis is subjective and invalid scientifically. Utility cannot be the foundation of a scientific demonstration - because it cannot be measured nor verified.
2. The theory of public choice presupposes - like all neoclassical thought - the existence of a homo economicus.[139] This model is often criticized as unrealistic[140] simplification.[141] Buchanan even acknowledges that it is reductionist.[142]
3. The theory of public choice is anti-democratic.[143]

Questioning democracy is not in itself a "heresy". But implicit in public choice is the uncomfortable idea that democracy is only an illusion, which implies that

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135 Birgir Runolfsson Solvason, *supra* note 113.
136 Robert Rubin, (Ancien ministre des finances américain), Courrier Internationale, X/99, p. 39.
137 Hayek. *La Route de la Servitude*, Paris: PUF (1985).
138 James Buchanan and Gordon Tullock, *The Calculus of Consent.* Ann Arbor: U of M Press. (1965) p. 45.
139 Sylvain Allemand, "Qui est *l'homo oeconomicus?* La documentation Française, 50 Ans de Problèmes Economiques, 22-29/IV/1998, p. 122.
140 *Ibid.* p. 123.
141 David Friedman "The Political Marketplace", Public Choice*: Economic Analysis Of The Political Market* Sec. V, Ch. 19.
142 Buchanan, *The Calculus of Consent.* (1965) p. 17.
143 Birgir Runolfsson Solvason, supra note 113.

the political system is finally determined by wealthy and for the wealthy. Thus, public choice can be criticized as merely a defender of oligarchic plutocracy. At this level, at least, it loses its ability to legitimacy in a system based - at least in theory - on the general consent and democracy.

VII. CONCLUSIONS:

A. Valid Applications of Economic Methods in Law– "Weak" Law and Economics

1. Balancing Tests

Because the ideas of Smith[144] and Ricardo[145] are, with qualifications, basically accurate, law and economics as a special theory to resolve particular cases can well be valid. Economic analysis can be used to ground otherwise vague and manipulable balancing tests via market values back into the real world. The monetization of competing and conflicting interests of plaintiffs, defendants and third parties to a legal conflict allows vague and manipulable balancing tests to be coerced into objective forms, provided monetary valuation is possible - a saleable good with adequate buyers and sellers to constitute a market is a necessary precondition to accurate market valuation.

2. Cost-Benefit Analysis

The economic valuation of costs and benefits is another way economic analysis can be used to determine the weight of competing interests. Hand's test is the most famous example of an economic argument used to determine a real world legal problem – if the cost to prevent the damage is greater than the damage that would result then, according to Hand's test, there is no duty at tort. Cost benefit analyses are a defensible method brought to legal decision making from economics and is certainly more objective than the indeterminable manipulations of legal realism or post-modernism.

144 People are self interested, but by achieving their own self interest the best collective interest is obtained thereby. WN: B.I, Ch.2, Of the Principle which gives Occasion to the Division of Labour in paragraph I.2.2

145 Trade creates interdependence and prosperity and thus ensures peace. Solomon W. Polachek, Carlos Seiglie, *Trade, Peace and Democracy: An Analysis of Dyadic Dispute*, Institute for the Study of Labour Discussion Paper No. 2170, (2006).

The use of economic analytical methods such as market valuation of competing interests, cost benefit analysis and even actuarial tables, present value of future income stream calculations as well as the law of supply and demand are valid ways to help decide legal cases because, though specific, they can be applied in context of other values which escape market valuation, often due to market failure (no buyers, or sellers, imperfect information, transaction costs, disequilibria of supply and demand etc.). I call the limited and specific use of economic methods *weak law and economics*. Weak law and economics, the limited use of certain methods of economic analysis to help solve legal disputes, is a perfectly defensible method of resolving at least some legal disputes. Economic methods of "weak" law and economics such as those described have a place in legal decision making.

I now however wish to explore and expose the stronger claims of law and economics as a general theory of law, a general method for resolving any legal dispute – those propositions, which I call *strong law and economics* are simply untenable.

B. Invalid Claims: "Strong" Law and Economics

Economic theories of law arose in the late 20th century to try to deal with the problems presented by legal realism – a general indeterminacy arising from a) moral relativism b) linguistic prescriptivism c) epistemological relativism d) a general crises in the economy, namely two depressions and two attendant world wars. Of course, the economic facts which created a crisis of confidence in legal determinicity are well known: but strong law and economics is not arguing that economic forces are the material base upon which the juridical superstructure is erected – that would be Marxism -- and, moreover, a perfectly defensible position. Rather, strong law and economics argues that laws mirror the market, that all legal conflicts resolve into economic conflicts and the position that law and economics provides a general method for resolution of all legal disputes. However that last point is indefensible.

Law and economics grew out of the mixed bag of economic thought sketched above. On the one hand Smith and Ricardo, who are well thought out, are the basis for the unrealistic claims of Pareto and Coase. The result of this mish-mash is a theory unable to maintain its totalizing claims.

Law and economics theorists argue that law is developed as a function of its tendency to maximize social wealth and that legal mechanisms parallel economic mechanisms. The "strict" or "strong" view of L&E argues that law reaches economically efficient outcomes and essentially mirrors results that would have been reached had laws and outcomes been negotiated on an open market.[146] The weaker version of L&E in contrast only looks to economics for methods of analyzing the law in order to inform the law as to what decision would be best. As a description, economic theory of law argues that all rights are *de facto*, and should be, *de jure,* fungible because they believe that the competition to buy and sell rights leads to wealth maximisation. Law and economics relies on untenable presumptions about the nature of man, the market and information which are exposed and refuted below.

Economic analysis of law, as a general theory, is severely flawed due in part to a contradiction at the ontological level between holism on the one hand and atomism on the other. Economic analysis of law tends to be atomistic not holistic. Holistic theory argues that entities should be studied in toto. A study that is not starting by encompassing the individual in their entire social context is inevitably doomed to failure; essentially, for holists, the whole is greater than the sum of its parts. According to the holistic perspective, the collective forms its members who can then flourish within the collectivity and even survive outside it.

Strong L&E is demonstrably false because it is based on erroneous theories about information and markets. Thus, legal processes cannot, do not, and should not mirror outcomes on an open market. You say "unregulated open market" and I respond: 1929. That is not the only example of market failure, just the most famous one.

1. Homo Economicus – An Unrealistic Model of Human Behaviour in the Real World

Law and economics, at least in its strong version, assumes the existence of a homo economicus. Homo economicus is a rational profit maximizer.[147] That assumption is questionable.[148] Economic actors are often irrational.[149]

146. Richard A. Posner, *Economic Analysis of Law* 491-99 (3d ed. 1986); William M. Landes & Richard A. Posner, *A Positive Economic Analysis of Products Liability*, 14 J. Legal Stud. 535, 535 (1985) (common law fosters efficient markets); Richard A. Posner, *A Reply to Some Recent Criticisms of Efficiency Theory of the Common Law*, 9 Hofstra L. Rev. 775 (1981) (common law rightly seeks wealth maximization). I take Aristotle's position: The state exists to enable us to live and to live well. Wealth is a means to this end but is not an end in itself.

147 Andrei Shleifer, Inefficient Markets: An Introduction to Behavioral Finance, 4 (2000).

148 Maurice Baslé et alia, *Histoire des pensées économiques - les contemporains*. Paris: Editions Sirrey (1988).Page 142.

149 *Id.* at 143.

Maximization of well being is highly individual and may be generally beyond (and at times surely is beyond) objective monetary evaluation. The better theorists admit the homo economicus is unrealistic and not a reflection of reality.[150] Profit maximization is only one of many possible goals of an economic actor and maximization of well being, utility or even income may well be incapable of market evaluation. Finally, just as there may be no buyers and sellers to constitute a market, the relevant goods may not be divisible and fungible. Market failure happens.

2. Presumptions about Markets – And Failure to Account for Market Failure

Neoclassical economic thought presupposes that goods are able to be evaluated in monetary terms and that they are fungible. To function, markets also require willing buyers and willing sellers. Without an adequate number of buyers and sellers trading in fungible goods markets don't exist. And without markets no economic solution is possible. Wherever markets fail law and economics would also fail which alone should explain what law and economic is no realistic contender for the role of total unifying theory of law and justice. Not all goods are fungible. Certain goods cannot in fact be priced even by a market economy. Other "goods" ("bads" in fact) should not be marketable and other goods are inalienable. Markets do not always exist and even when they do sometimes markets fail to allocate goods efficiently – gluts, shortages and depressions are part of the economy.

In sum, strong law and economics is descriptively incorrect. Courts are not mini-markets mimicking or mirroring the marketplace nor should they be both due to the methodological limits of economic analysis and due to the non-economic character of much in the law (e.g., inalienable rights, interpretation of texts).

Because of the weaknesses in economic analysis of the law, which inevitably arise from any simplified descriptive model, strong L&E is not very useful as a tool to describe legal reality and is quite useless as a prescriptive model of how legal reality ought to be. Yet, a weak form of L&E, borrowing some methods of classical economics, can be a useful tool for legal analysis. For example, the cost-benefit analysis in law is a result of weak L&E.

150 Friedrich von Hayek, "LSE Essays on Cost" in James Buchanan & G. Thirlby eds., *Economics and Knowledge*, New York: NYU Press (1981).

3. Information Theory

For law and economics, money is simply a quantum of information – monetary flows reflect information flows (Hayek). This is one of the contributions of L&E to social sciences. Other aspects of L&E information theory are however problematic.

Strong L&E embraces the pernicious and inaccurate view that information flow is perfect (i.e. instantaneous and complete) and that there are no transaction costs, such as lawyer's fees, brokers commissions, translation fees, etc.[151] Likewise neoclassical economics argues that information is perfect with no transaction costs - that is simply not the case.[152] The Chicago school's efficient capital market hypothesis is built on this of this erroneous theory of information (perfect information, no transaction costs)[153] Though information is almost instantly available at very low costs, finding and using that information is neither instant, nor costless, nor evenly distributed. Further, the Chicago theory ignores the existence of false and misleading information, as well as the inevitability of transaction costs such as legal formalities and translations.[154] The Chicago theory also ignores market entry costs. Although thinly capitalized start up companies are normal in the English speaking world, this is not the case in civil law jurisdictions. Moreover, even if a thinly capitalized company can enter the market with low costs, it is still limited by material capital requirements for production, such as machinery, vehicles, and land. So while information costs are dropping all the time, entry costs and transaction costs have not been eliminated. Thus capital markets are not perfectly efficient.[155] The ECMH is in fact only partially correct because some market imperfections are inevitable due to the inevitability of cyclicity and unemployment and is just one example of how law and economics fails as a theory either to describe what reality is or to prescribe what it should be. In sum, information flow is not perfect. Transaction costs are inevitable. Thus strong l&e cannot hold.

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[151] *See,* Theresa A. Gabaldon, *Assumptions about Relationships Reflected in the Federal Laws*, 17 Wis. Women's L.J. 215 (2002).

[152] *See*, Investor Home, *The Efficient Market Hypothesis & The Random Walk Theory*, at http://www.investorhome.com/emh.htm

[153] *See,* Worapot Ongkrutaraksa, *Efficient Capital Markets: A Review of Literature*, at http:// www.geocities.com/WallStreet/Exchange/3663/Worapot09.html

[154] *See,* Joint Impact, Transaction Cost Economics--A Summary, at http:// members.ozemail.com.au/~>cgold/transaction%costs.htm

[155] *See,* The Electric Law Library, at http:// www.lectlaw.com/def/c161.htm

C. Why Law and Economics?

Economic analysis of law rose to prominence in the common law in part because of the common law's tendency to pragmatism and tendency to monetise.[156] Economic analysis was one response to indeterminacy in legal realism's proposed solution to formalism, multipronged interest balancing tests. Balancing tests are flexible, so flexible as to be indeterminate. Flexibility permits the court to decide cases on their individual merits but can also be criticized as capricious, unprincipled, and prone to abuse--a critique which can be levelled at balancing tests generally.[157] However, economic analyses are sometimes only pseudo-empirical because it is at times difficult or even impossible to objectively evaluate worth. Economic analyses of law can be superficial and are in all events no judicial panacea. Some values defy market valuation (no market, either due to lack of buyers or sellers), other values are not fungible (fundamental human rights are inalienable) and several of the presumptions of economic analysis are questionable when not outright wrong. However, economic analyses at least appear objective and this explains why they rose to prominence to meet the problem of legal indeterminacy brought about by moral relativism.

D. A Reductio to Refute Strong Law and Economics

The limits of economic reasoning about the law can be shown by a reductio: If there were no personal sphere of existence apart from the economic than slavery[158] and contract killing would be permitted as leading to the efficient use of slaves and the useful elimination of uneconomic actors. Similarly: if the act of executing an innocent person would increase collective wealth, Posner's logic would, at least on the face of things, affirm the death penalty for the innocent person.

In sum, Posner's thinking is reductionist.[159] He argues that all legal principles can and/or should be able to be derived from an economic analysis. His over-

156 *See*, e.g. Landesand, Posner, The Economic Structure of Tort Law, Cambridge: Harvard Univ. Press (1987).
157 *See,* Mathew Africa, The Misuse of Licensing Evidence in Fair Use Analysis: New Technologies, New Markets and the Courts, 88 Cal. L. Rev. 1145, 1149 (2000).
158 Richard Posner, *Economic Analysis of Law*, Boston: Little Brown (1977) p. 86-87.
159 Lloyd and Freeman (eds), *Lloyd's Introduction to Jurisprudence,* (5th Edition) London: Steven and Sons (1985), page 431.

determinism deserves to be criticized[160] Hopefully this refutation is adequate.[161]

[160] *See*, David Friedman, "Anarchy and Efficient Law" in John Sanders and Jan Narveson eds., *For and Against the State*, by Rowman and Littlefied 13-16 (1996). Friedman also critiques Posner in Friedman, *Price Theory*, Chapter 15. Lloyd's Introduction to Jurisprudence,

[161] Ronald Dworkin, "Is Wealth a Value" in Lloyd and Freeman (eds), *Lloyd's Introduction to Jurisprudence,* (5th Edition) London: Steven and Sons (1985), at 517 similarly refutes Posner.