

## **Comparative Institutional Law and Economics: Reclaiming economics for Socio-Legal Research**

*Law and economics is a controversial method of legal research, increasingly popular amongst some legal scholars but hated by many others. The author discusses some of the objections raised by lawyers (as well as some economists) and argues that most of these are caused by the employment of the wrong economics on the respective side of the conjoined field. She contrasts neoclassical economics, made extremely popular by the Chicago School and Prof. Richard Posner in particular, with the New Institutional Economics and argues that the latter can overcome the difficulties presented by the former. While neoclassical economics seems to introduce additional problems to legal scholarship, New Institutional Economics neatly matches law's own methodological tenets. However, the analysis will remain incomplete unless a third element is added to the mix, Comparative law. Thus, she calls for the development of a Comparative Institutional Law and Economics which alone can be epistemologically satisfactory.*

The interaction of law with the social scientific discipline of economics has often caused tensions in the generalist legal community. Legal scholars frequently equate the application of economic theory to legal rules with ethical bankruptcy and dethroning law from its position of autonomous discipline. With its recommendations for market-based approaches and against state intervention law and economics is opposed by many on political grounds too. Economic analysis of law has also repeatedly been accused of disregarding the environment in which legal institutions are embedded and generating unworkable universal solutions. This has led to a cold acceptance of Law and Economics in Europe and to many legal scholars consciously eschewing the economic instrumentarium. In my view, while not without basis, the criticisms have largely resulted from a hasty and superficial engagement of the two disciplines. It is only one version of economics that is peddled by the Chicago School and that is admittedly the most common one, that can be blamed for complacency and universalism. The main purpose of this paper is to contrast this to a more sophisticated approach that is readily available but is little known outside of the ghetto reserved for economically minded lawyers. Thus, I shall show first that the New Institutional Economics (NIE) does not suffer from three major deficiencies that pervade the pervasive Posnerian analysis. Second, I will turn to NIE's own limitations when applied to law. Further, I shall argue that good, sophisticated economic analysis requires rescuing the concept of efficiency from the grip of the universalistic neo-classical economics and infusing it with context by applying the comparative law and economics method. Combining New Institutional Economics and comparative law, this innovative interdisciplinary methodology is able to overcome the shortcomings of each of the disciplines taken separately and inject the field of law and economics with new analytical power. Thus, I shall propose the development of a Comparative Institutional Law and Economics approach which alone, I argue, enables analysis of legal phenomena which is sufficiently complex and subtle and yet grounded in social reality.

### **A. Universality of Law and Economics**

It will not be wrong to say that to this day legal scholars, who are not themselves doing law and economics associate the economic ingredient of the discipline predominantly with the Chicago school of thought. In a way this is not surprising. It is the University of Chicago where it all started and it was Chicagoans that extended the application of law and economics to all areas

of life.<sup>1</sup> In addition, the elegance and precision of Chicagoan models makes them attractive to policy-makers who naturally prefer clear-cut predictions and recommendations. The major contribution of the Chicago school is that it developed a systematic way of thinking of law reform that entails a steady application of a coherent body of economic theory (price theory) to legal rules. Where legal rules constitute prices of illegal conduct, they produce incentives to which rational individuals respond. Increase in the price, be it by providing for higher damages in case of tortious acts or breach of contract, or for heavier fines and longer jail time in case of criminal activity, would make illegal conduct more costly and incentivize actors to reduce it.<sup>2</sup> Structuring, then, legal rules in terms of the incentives they induce, we are able to affect human behavior in a way that would produce the desired result.<sup>3</sup> This is the logic that is at the heart of the Chicagoan approach to law and economics. It will not be an overstatement to say that by methodically cultivating it, Chicagoans raised awareness about the consequences and trade-offs that follow from policy choices and opened the door to a better understanding of the relationship between the legal options on hand and the outcomes sought.

Yet, while having attracted a large following, Chicagoan law and economics, has also drawn a great deal of criticism. Neoclassical economists view themselves as equipped with universal analytical tools that could be applied to any field.<sup>4</sup> But while studying the phenomenon that has enticed their interest, they detach it from the particular background in which it operates. The concrete legal institution explored is largely isolated from the legal and social framework in which it is applied and is, instead, set in the theoretical construct of a perfectly competitive market. The latter inevitably comes with its basic and overly strong assumptions of well-defined rights and their complete enforcement as well as with the extreme focus on decentralized decision-making. The very emergence, the nature and the process of development of the rights' structure is disregarded. If, after all, an important characteristic of the institutional context cannot be ignored, it is always positioned as an exogenous factor. As a result, the way the studied legal institution fits and interacts with others within the working of the larger system remains generally hidden from view. As for transaction costs, they are traditionally assumed to be zero. Even if they are introduced in the model, this is done only in a rudimentary fashion, without disciplined accounting for their source or nature. It is sufficient to look at the neoclassical models concerning contractual damages in which transaction costs are assumed only for the purpose of excluding renegotiation to realize that another vehicle through which particularities can enter the picture is completely underrated. With all possible complications tucked away, it comes as no surprise that neo-classical law and economics is capable of making bold claims as to universality of its solutions.

In fairness, the mentioned features of neoclassical economic analysis of law should not be blamed only on the economics side of the discipline. The legal scholars, who embraced law and economics, did little to question the initial assumptions with which economists approached law. Usually US-trained, they directed their attention to the legal system they knew best and thus, showing no comparative interest, brought in tacit positivist postulates viewing law as a coherent product of one state and not as the messy social phenomenon it is. Such an implicit positivist

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<sup>1</sup> For example, the Nobel Prize laureate Garry Becker applies economic analysis to family relations. For a short history of Chicago Law and Economics, see Nicholas Mercuro and Steven G. Medema, *Economics and the Law. From Posner to Post-Modernism and Beyond* (Second edn, Princeton and Oxford: Princeton University Press 2006) 94-102.

<sup>2</sup> Ibid 104.

<sup>3</sup> Ibid 104, 33.

<sup>4</sup> Law is hardly the only discipline that has seen the penetration of economic analysis. In political science, for example, economic analysis has been applied to non-market political decision-making to produce public choice theory.

outlook is underlain by the same assumption of fully defined rights and their enforcement without transaction cost limitations which is so typical of perfectly competitive markets.<sup>5</sup> Unspoken remnants of the positivist paradigm also positioned the American common law process as a naturally presumed setting, a setting that matched extremely well with the economic emphasis on decentralized decision-making. Thus, tacit legal assumptions, rooted in legal positivism, only reinforced the rigidities of economic theory. They have also fueled its universal ambitions. Failing to recognize the silent incorporation of local factors in the analysis, American law-and-economics scholars readily export US solutions to other legal systems. In this way law and economics is a meeting of two universalisms: the universalism of economics stemming from the creation of an ideal, yet virtual reality which is doubled up by the amplitude of American epistemic imperialism stemming from subconsciously operating positivist traces.

This does not come to say that neoclassical economic models are useless. On the contrary, they represent important analytical and educational tools which provide essential information how behavioral incentives are affected by legal institutions and what are the trade-offs between stimulating one incentive or another. In my own research I myself have not simply ignored the received neoclassical wisdom. On the contrary, I have spent a great deal of time and effort studying the effects generated by contractual damages and the way economists adapt this knowledge to other contractual remedies. Yet, my point is that the capacity of neoclassical economic models to evaluate legal institutions in terms of their incentive effects is also the outer limit of their universal claim. Once this limit is reached it is necessary to step into the real world since much of the insight can be gained not by keeping hold of the models but by examining the imperfect environment and its particularities.

Yet law and economics has experienced considerable branching out and it is by no means mandatory that economic analysis be based on neoclassical economics.<sup>6</sup> Neither is it inevitable that the analysis is affected by residual positivist biases deeply ingrained in legal thinking. Thus, I advocate the employment of a comparative law and economics method which joins New Institutional Economics and Comparative Law. I shall focus on the economic element first, and turn to the legal side in the section that follows.

## **B. New Institutional Economics**

Three differences between the Chicago tradition and New Institutional Economics speak in favour of the latter school when applying economic analysis to law: first, the degree of realism achieved by economic analysis; second, the more subtle position taken with regard to the deregulation/regulation debate; and third, the developed dynamic framework.<sup>7</sup> These methodological differences turn out to be not negligible at all as they lead to a different understanding of efficiency and to the specific take comparative law and economics has on the standard.

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<sup>5</sup> In a similar vein, see Antonio Nicita and Ugo Pagano, 'Law and Economics in Retrospect' in Éric Brousseau and Jean-Michel Glachant (eds), *New Institutional Economics: A Guidebook* (First edn, Cambridge, UK; New York: Cambridge University Press 2008)

<sup>6</sup> Mercurio and Medema distinguish Chicago Law and Economics, Public Choice Theory, Institutional Law and Economics, New Institutional Law and Economics, New Haven School, Modern Civic Republican School. Mercurio and Medema. In addition, Behavioural Law and Economics took off during the 1990's of the last century.

<sup>7</sup> On the fundamental building blocks of the Chicago approach and of New Institutional Economics, see Mercurio and Medema 102-126; 241- 276.

## 1. The Degree of Realism

By relying on very strict premises the Chicago approach created a sort of "economic nirvana"<sup>8</sup> which, according to Ronald Coase, has little to do "with what happens in the real world."<sup>9</sup> In this approach, individuals, being rational maximisers of their satisfaction, respond, in the context of perfect markets, to price incentives embedded in the legal rules, the latter devised with an efficiency purpose. Although wealth-maximisation and the means to achieve it lie also at the core of New Institutional Economics<sup>10</sup> the latter has moved well beyond the neoclassical and even the post-neoclassical paradigm. First, the introduction of the concept of transaction costs to economic analysis<sup>11</sup> pointed at the illusory comfort of the world in which mainstream economists lived – an ideal world in which there are no costs of search, negotiation, monitoring and enforcement.<sup>12</sup> However this may be not the radical departure that it seems to be as post-Chicago scholars are also aware of the importance of transaction costs and the need to take economic thinking beyond the idea of perfect markets.<sup>13</sup> Second, the assumption of full rationality is relaxed in order to base the new institutional analysis on the concept of bounded rationality.<sup>14</sup> Again, some post-Chicagoans also realise the need to integrate a more realistic model of behaviour in their approach.<sup>15</sup> The true progress made by New Institutional Economics, I think, is rooted in the way the analysis proceeds that makes it less abstract and more sensitive to the actual facts. It takes the concept of transaction costs seriously, viewing them not merely as barriers to exchange to be eliminated but as the product of the particular institutional arrangements in the specific context which themselves need to be analyzed.

At the beginning of the analysis is always the Coase theorem.<sup>16</sup> In a world of zero transaction

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<sup>8</sup> Nicita and Pagano.

<sup>9</sup> Ronald Coase, 'The New Institutional Economics' (1998) 88 *The American Economic Review* 72, 73. For the debate between Coase and Oliver Williamson, on one side, and Richard Posner, on the other side, see Richard Posner, 'The New Institutional Economics Meets Law and Economics' (1993) 149 *Zeitschrift für die GesamteStaatswissenschaft (Journal of Institutional and Theoretical Economics)* 73; Ronald Coase, 'Coase on Posner on Coase: Comment' (1993) 149 *Zeitschrift für die GesamteStaatswissenschaft (Journal of Institutional and Theoretical Economics)* 96; Oliver Williamson, 'Transaction Cost Economics Meets Posnerian Law and Economics' (1993) 149 *Zeitschrift für die GesamteStaatswissenschaft (Journal of Institutional and Theoretical Economics)* 99; Ronald Coase, 'Concluding Comment' (1993) 149 *Zeitschrift für die GesamteStaatswissenschaft (Journal of Institutional and Theoretical Economics)* 360.

<sup>10</sup> Ronald Coase, 'The Problem of Social Cost' (1960) 3 *The Journal of Law and Economics* 1; Oliver Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (New York: Free Press, London: Collier Macmillan 1985) 23.

<sup>11</sup> Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386; Coase, 'The Problem of Social Cost'.

<sup>12</sup> Ronald Coase, *The Firm, the Market and the Law* (First edn, Chicago: University of Chicago Press 1988) 7.

<sup>13</sup> See e.g. Charles Goetz and Robert Scott, 'The Mitigation Principle: Toward a General Theory of Contractual Obligation' 69 *Virginia Law Review* 967.

<sup>14</sup> Herbert Simon, *Administrative Behaviour* (Second edn, New York: Macmillan 1961) 24. Some new institutional economists even strive to go beyond the concept of bounded rationality. Exploring how humans decipher the environment through pre-existing mental constructs, they aim at explaining the institutional choices made and the effect of these choices on the economy. Douglass North, *Institutions, Institutional Change and Economic Performance* (First edn, Cambridge: Cambridge University Press 1990); Douglass North, 'Prologue' in John Drobak and John V.C. Nye (eds), *The Frontiers of the New Institutional Economics* (First edn, San Diego: Academic Press 1997) 11. In this aspect the new institutional economic literature intersects with experimental-behavioural law and economics.

<sup>15</sup> Eric Posner, 'Economic Analysis of Contract Law after Three Decades: Success or Failure' (2003) 112 *The Yale Law Journal* 829 865-868, 875-877. To be more correct, although Erik Posner is conscious of problems with the rationality assumption, he is also very sceptical of the capacity of bounded rationality models to better inform economic analysis of contract law.

<sup>16</sup> In fact, Coase himself did not explicitly state the Coase theorem. It can be induced from Coase, 'The Problem of Social Cost'.

costs, law does not matter since parties will always bargain for the one efficient outcome. Our world, however, is a world of positive transaction costs and in it, law has important efficiency implications.<sup>17</sup> In the imperfect human universe parties will bargain not until the right reaches its most valued user but until the expected gains exceed the expected costs. So how the particular right is initially assigned determines its final place. For the law to be efficient, it should structure property rights in a way which minimises transaction costs and maximises society's wealth.<sup>18</sup> So far, so good; Chicagoans and New Institutionalists would not, I think, disagree on this.<sup>19</sup> But what are the concrete steps to be taken in the process of finding the efficient legal solutions? Here is where the most significant differences start.

The logic of the Chicago analysis roughly proceeds as follows: An optimal model is constructed under the assumption of zero transaction costs. The hypothetical legal rule enabling the parties to achieve the outcome in the optimal model is identified. The existing legal rule is then compared to the optimal one: if it is the same, the effective law is efficient; if it differs, then it is criticised as a rule that does not lead to an optimal result and, therefore, should be changed. The exercise may also include changes in the assumptions of the zero-cost model to discern different rules that are efficient under different conditions. Then again it will be seen whether the real-life rule fits any of the efficient ones.<sup>20</sup> New Institutional Economics, however, sets on a different route of analysis: The different real-life institutional solutions to a problem are identified. Then the particular institutional framework is investigated in order to discover the factors determining transaction costs and the types of transaction costs associated with each of the solutions. Further, the different institutional arrangements are compared in terms of costs. The appropriate institution then becomes the one that implies the lowest level of transaction costs.<sup>21</sup>

Obviously, both schools aim at getting as close as possible to the zero-transaction-cost world. Why then is the methodological procedure of New Institutional Economics to be preferred? The problem with the Chicago approach is the continuous, invariable emphasis on the optimal model. In the Chicagoan vision, the ideal world should be approximated by imitation, by replicating it as if it actually exists. If parties cannot reach the efficient allocation of property rights as a result of transaction costs, the law should help them attain the outcome as if there were no barriers to exchange. Costs are minimised by assuming zero costs and assigning rights and liabilities as if this assumption were correct. The rights go to the party that would have purchased them as the highest value user; the liabilities go to the party that would have assumed them as the least cost avoider.<sup>22</sup> Yet, the assumption is not correct since no matter how much transaction costs are reduced, they are never completely eliminated and there will

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<sup>17</sup> It is often the case that only one of the assumptions, on which the Coase theorem rests, is emphasised – that of zero transaction costs (including information costs). For this reason it will be useful here to recall the other two assumptions which are just as important: (1) that the rights over the resources are fully defined, and (2) that the legal rights are alienable. Mercuro and Medema 110, 113. For more on these two assumptions, see *infra* Section C.

<sup>18</sup> This is known as the Coase lesson. For a detailed proof and interpretation of the Coase theorem, see *ibid* 107-119.

<sup>19</sup> For this reason Coase is considered a founding father of both schools. It is also for this reason that Mercuro and Medema view New Institutional Economics as being in many respects consistent with the Chicago approach. *Ibid* 243.

<sup>20</sup> For a similar description of the Chicago thinking, see Posner, 'Economic Analysis of Contract Law after Three Decades: Success or Failure' 833-834.

<sup>21</sup> This rough description is distilled from the methodological account in Chapter 1 *Transaction Cost Economics* of Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*.

<sup>22</sup> The same reasoning stays behind the efficient breach principle under which the promisor should be allowed to breach the contract if the gains from the breach exceed the costs.

always be costs of defining and enforcing property rights.<sup>23</sup> We simply cannot arrive at the ideal world by imagining we are actually there.

New Institutionalists, on the other hand, have accepted that this is unfeasible, so the emphasis is on where we are now, not on where we want to be. They study existing alternative governance institutions and aim at economising on transaction costs by endorsing the institution which governs exchange at the lowest cost level. Saving takes place not by mechanically reproducing the situation parties would be in if transaction costs were absent but by choosing the real-life workable arrangement that is the most cost advantageous. Moreover, as transaction costs depend on the particular institutional framework, the recommended solution is also determined with regard to the specific context. In this way, New Institutional Economics moves away from the "economic nirvana" and adopts an analytical technique that enables more accurate conclusions.

In other words, although neoclassical economic models are educational if one wants to view legal rules in instrumental terms, it is important not to forget that they are only normative constructions that largely assume a non-existent state of the world. Often, they leave out important variables either because the latter do not appear as crucial within the ideal world, or because the scholar is focused on coming up with clear-cut recommendations. Other, more sophisticated models include the relevant variables but can lead to definite conclusions only if there is statistical data which can be punched into the model to make it operative.<sup>24</sup> In contrast, New Institutional Economics investigates in detail the sources of transaction costs in particular contexts and attenuates the quantification difficulty by comparing the costs of diverse institutions. Instead of being paralysed by the absence of data on the amount of costs, it draws conclusions from their difference. This is how lawyers, without being too much preoccupied with computation problems, can make a substantial contribution in this analytical procedure as they are well-trained to recognise the transaction costs depending on the national legal system.

## *2. The Position in the Deregulation/Regulation Debate*

The Chicago school invariably insists on the necessary connection between efficiency and the market. If the efficient allocation of property rights can be reached by parties' contracting, the reasoning goes, the law should facilitate exchange by providing for maximum tradability of property rights at low cost. It should ensure the conditions for achieving the efficient outcome by excluding any restrictions on freedom of contracting and by "mimicking the market". Such an interpretation of the Coase theorem is easily translated into the normative recommendation of minimum regulation. Public regulation is viewed as an additional source of transaction costs, obstructing the operation of competitive markets and generated, among other things, by regulatory capture.<sup>25</sup> To this prescription also contributes the view of the efficiency of common law (broadly understood as judge-made law).<sup>26</sup> According to Posner, the common law

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<sup>23</sup> Steven Cheung, 'On the New Institutional Economics' in Steven Cheung (ed), *Economic Explanations: Selected Papers of Steven Cheung* (First edn, Hong Kong: Arcadia Press Ltd. 2005) 248-250; Robert Cooter and Thomas Ulen, *Law and Economics* (Fifth edn, Pearson/Addison-Wesley 2008) 94; Robert Cooter, 'The Cost of Coase' (1982) 11 *Journal of Legal Studies* 1 11.

<sup>24</sup> See in this sense Posner, 'Economic Analysis of Contract Law after Three Decades: Success or Failure'.

<sup>25</sup> George Stigler, 'The Theory of Economic Regulation' (1971) 2 *The Bell Journal of Economics and Management Science* 3.

<sup>26</sup> Richard Posner, *Economic Analysis of Law* (First edn, Boston: Little, Brown 1972); George Priest, 'The Common Law Process and the Selection of Efficient Legal Rules' (1977) 6 *Journal of Legal Studies* 65; Paul

incentivises players to "channel their transactions through the market" or, in case of high transaction costs, simply reproduces the outcome that would have been obtained, had costs not impeded market operation.<sup>27</sup> Its efficient legal doctrines make state intervention through statutory regulation unnecessary, all the more that the legislative process does not have the means to produce efficient results, whether these means are the party's choice between settlement and adjudication,<sup>28</sup> an evolutionary mechanism, driven by the utility-maximising decisions of litigants,<sup>29</sup> or the utility function of judges as determined by the institutional structure of the adjudicative system.<sup>30</sup> In short, the decentralised decision making of the free, self-correcting market generates efficiency and if a market failure occurs, it is sufficient to rely on the common law to bring about the efficient outcome.

Such a view, however, does not accord well with the mounting evidence suggesting an increasing regulatory role of private law. Truly, this evidence suggests a diminishing importance of public regulation but, still, it also implies that the market does not always function efficiently and that market failures need correction. It entails a trend from a command-and-control to incentive-based regulation, not a trend toward deregulation as advocated by the Chicago school. From the above short account of the Chicagoan viewpoint it is clear that the origin of the market bias lies in the way Chicagoans construe the Coase lesson. In their view, the role of law should only be to define property rights and to assign them to the party who values them most since this would be the result from the market operation in the zero-transaction-cost world. Yet, as explained, such a laissez-faire attitude would lead to efficiency only if it actually brings about the ideal world, an outcome that is highly unlikely.<sup>31</sup>

The source of market favouritism, however, can also be found in the natural law model of property rights which is at the basis of neoclassical economics. This is the model on which Adam Smith, defying mercantilism, grounded his theory of the invisible hand.<sup>32</sup> Setting out to formalise Smith's doctrine, the Chicago school embraced the natural law definition of property rights, implying a sovereign dominion of the individual, in which he is free from any government intervention and has an unrestricted bundle of rights over certain resources

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Rubin, 'Why Is the Common Law Efficient?' (1977) 6 *Journal of Legal Studies* 51; John Goodman, 'An Economic Theory of the Evolution of Common Law' (1982) 7 *Journal of Legal Studies* 393.

<sup>27</sup> Richard Posner, *Economic Analysis of Law* (Fourth edn, Boston: Little, Brown 1992) 252.

<sup>28</sup> Coase, 'The Problem of Social Cost'; William Landes, 'An Economic Analysis of the Courts' (1971) 14 *Journal of Law and Economics* 61.

<sup>29</sup> Rubin; Priest.

<sup>30</sup> Richard Posner, 'What Do Judges Maximise (The Same Thing Everybody Else Does)' (1993) 3 *Supreme Court Economic Review* 1.

<sup>31</sup> For such an argument, see also Simon Deakin and Frank Wilkinson, 'Labour Law and Economic Theory: A Reappraisal' in Gerrit De Geest, Jacques Siegers and Roger van den Bergh (eds), *Law and Economics and the Labour Market* (First edn, Northampton, MA: Edward Elgar 1999); Simon Deakin, 'Law versus Economics? Reflections on the Normative Foundations of Economic Activity' in Megan Richardson and Gillian Hadfield (eds), *The Second Wave of Law and Economics* (First edn, Sydney: The Federation Press 1999).

<sup>32</sup> Smith's *Wealth of the Nations* was a reaction against the mercantilist policies dominating at the time. Under them the State, enacting many protectionist command-and-control regulations, became deeply involved in the economy. At that time the natural law framework was already introduced in England by Sir William Blackstone. William Blackstone, Sir, *Commentaries on the Laws of England*, vol 4 (Oxford: Clarendon Press 1765-1769). In Smith's view, a property rights structure such as the one delineated in the natural law model, made the heavy government intervention, advocated by mercantilists, unnecessary, as the invisible hand of the free market would automatically channel the efforts of self-interested individuals toward socially desirable ends. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of the Nations* (First edn, 1776), available at: <http://www.gutenberg.org/ebooks/3300>. For a more detailed interpretation of the historical context in which Adam Smith developed his invisible hand doctrine, see Ugo Mattei, *Comparative Law and Economics* (First edn, Ann Arbor: The University of Michigan Press 1997) 40-46.

(property). Developed by civil lawyers, the natural law concept was divorced from the idea of obligation, necessary to control externalities, and any property right limitation was equated with limitation to freedom. Such absolute property rights were to be assigned by private law with any constraints contained only in public law regulation.<sup>33</sup> This model remained largely an intellectual product and never underlay in its pure form the property rights structure in any legal system.<sup>34</sup> Yet, it became the background against which mainstream law and economics developed its theory, placing great emphasis on the free market and perceiving any restraint on it as exogenously imposed.<sup>35</sup>

Even after Coase had reconnected property rights and liability,<sup>36</sup> mainstream economists did not re-examine the property right concept which continued to encompass a zone of "liberty over things" and to disregard the fact that in any legal system right-holders also have obligations.<sup>37</sup> Searching for new methods to fill the void opened by Legal Realism<sup>38</sup> many US legal scholars adopted economic insights without critically questioning them. Economic theoretical concepts were espoused without explicitly dispelling the natural law assumption, but as Coase had opened the door to real-world legal institutions, the analysis was directed to US law. Thus, the deregulation ideal backed by the natural law model, received a new support by the institutional structure of the American legal system which allots an important role to courts and much less faith in centralised decision-making. In this sense, the already existing misconception was not dismissed but another layer of confusion was added – the home country bias, the latter, as already explained rooted in unabandoned, tacitly operating legal positivist postulates.<sup>39</sup>

Nevertheless, Coase's "The Problem of Social Cost" paved the way for a genuine shift in the way legal-economic analysis is carried out. Coase rejected the zero-transaction-cost world as an ideal place in which the absence of costs makes any institutions, even markets, useless.<sup>40</sup> Bringing actual, existing law into the analysis, he made the first step of moving away from the natural law model, which is at the root of economic theory. In addition, his account showed that along with the *ex ante* centralised model of regulation, the only one imagined by economists until then, there exists a functionally equivalent *ex post* decentralised model, operating through the imposition of remedies in private causes of action.<sup>41</sup> Truly, the shift in the established paradigm turns out to be long and difficult since the Coase theorem continues

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<sup>33</sup> On the natural law model in civil law, see Mattei 33-38.

<sup>34</sup> Although influential, the model was subsequently challenged and discarded by civil lawyers. Ibid. In the common law tradition, it found its way in scholarly writings, particularly in Blackstone's Commentaries, but was never adopted by common law judges. Consequently, it never infiltrated the very roots of the legal system. On the common law model, see Mattei 39-40.

<sup>35</sup> For a more elaborate account of the natural law misconception in neoclassical economics, see Mattei Chapter 2 The Economist's Legacy to Law and Economics: The Natural Law Misconception in Historical and Comparative Perspective 27-67.

<sup>36</sup> Coase, 'The Problem of Social Cost'.

<sup>37</sup> Robert Cooter and Thomas Ulen, *Law and Economics* (Sixth edn, Boston: Pearson Education, Inc. 2012) 73-74.

<sup>38</sup> On the disillusionment with law's autonomy caused by Legal Realism and the growth of numerous "law and..." movements as a search for means to re-legitimate law, see Mercurio and Medema 14-19. For a similar argument, see also Mattei 57.

<sup>39</sup> See *supra* Section A. For more on the home country bias underlying law and economics, see *infra* footnote 87 and the text accompanying it in Section C.

<sup>40</sup> Coase, *The Firm, the Market and the Law* 7. "The world of zero transaction costs has often been described as a Coasean world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave." *ibid* 174.

<sup>41</sup> Later Williamson directed the attention also to private regulation. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*.



to be misread as ruling out state intervention.<sup>42</sup> One reason for this is that New Institutionalists have not yet come up with a theory on the choice between public and private law.<sup>43</sup> But they have made a great progress in digging out the options of institutional control available in different contexts and retreating from the automatic universal recommendation that the market should be left to do its job.

What makes New Institutional Economics valuable for the economic analysis of law is its premise that the institutional framework, of which the legal framework is a part, matters for economic performance.<sup>44</sup> Institutions determine the level of transaction costs both at the micro-level of contracting between private parties and at the macro-level of the economy as a whole.<sup>45</sup> When talking about efficient markets, the logic unfolds, economists already assume a complex set of institutions which on balance promote the efficient operation of the market.<sup>46</sup> That is, the market is not efficient *per se*, its efficiency depends on the institutional structure, so improvement in economic performance requires investigation of the way different institutional frameworks enhance efficiency.<sup>47</sup> In this analysis the optimal, though not perfect solution may be provided by whatever real-life arrangement is found to exist: *ex ante* or *ex post*; statutory law, judge-made law or private ordering; or any combination between them. In this sense, in the world of transaction costs, market solutions are only one of the possible alternatives among others, with the range of possibilities including command-and-control as well as responsive regulation.<sup>48</sup> The superiority of any alternative can be claimed only after careful comparative institutional analysis revealing the pros and cons of each of the options.<sup>49</sup> Separate from the market, efficiency becomes a theoretical concept dependent on the particular institutional context. With law being a vital part of this context,<sup>50</sup> a legal researcher may proceed with her mind clear and eyes wide open about comparing different legal institutions in different jurisdictions. Yet, as there is not one single efficient solution, it cannot be said from the outset which country's legal institutions are more efficient. Such a conclusion requires an in-depth examination of the types of transaction costs generated by the legal-economic environment in each jurisdiction. What is more, as efficiency no longer constitutes an absolute yardstick for comparison, recommendations will probably differ with regard to each of the countries on a case by case basis. Thus, the higher subtlety of the positive institutional analysis will most probably lead to more subtle and dissimilar normative prescriptions.<sup>51</sup>

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<sup>42</sup> Cooter called the confusion about the generalisations which follow from the Coase theorem "the cost of Coase". Cooter, 'The Cost of Coase'.

<sup>43</sup> Thomas Ulen, 'The Future of Law and Economics' in Fabrizio Cafaggi, Antonio Nicita and Ugo Pagano (eds), *Legal Orderings and Economic Institutions* (First edn, London and New York: Routledge 2007) 33.

<sup>44</sup> Institutions constitute "the rules of the game in a society", they are "the humanly devised constraints that shape human interaction" by structuring "incentives in human exchange, whether political, social or economic". North, *Institutions, Institutional Change and Economic Performance* 3.

<sup>45</sup> Ibid 61-69.

<sup>46</sup> Ibid 64-66.

<sup>47</sup> See also for such an understanding of the New Institutional Economics theory Mercuro and Medema 241-245.

<sup>48</sup> For such an interpretation of the Coase theorem see Deakin, 'Law *versus* Economics? Reflections on the Normative Foundations of Economic Activity'; Deakin and Wilkinson, 'Labour Law and Economic Theory: A Reappraisal'.

<sup>49</sup> In this respect Coase was most explicit. See Coase, 'The Problem of Social Cost' 18-19; Coase, *The Firm, the Market and the Law* 117-118; Ronald Coase, 'Law and Economics and A. W. Brian Simpson' (1996) 25 *Journal of Legal Studies* (Oxford University Press, Oxford, UK, January 1996) 103.

<sup>50</sup> Institutions include formal rules (constitutions, laws, regulations) and informal constraints (conventions, norms of behaviour, self-imposed codes of conduct). North, *Institutions, Institutional Change and Economic Performance* 4.

<sup>51</sup> This account of the advantages of New Institutional Economics, of course, does not mean that all research, which builds on the claim that institutions matter and uses inter-jurisdictional comparative analysis of legal institutions, automatically avoids all theoretical and methodological problems. Thus, the studies associated with the New

### 3. The Dynamism of the Framework

Chicago legal-economic analysis is remarkably static.<sup>52</sup> With models omitting the dynamics of the economic and the legal system, neoclassical theory is able to draw a picture concerning only a particular point of time. Relying solely on an *ex ante* comparison between the costs and benefits of the introduction of a rule, the Coase model also misses the dimension of legal-economic change. Thus, for example, a legal rule compensating externalities may preclude the rise of welfare-enhancing business in the short run, but in the long run it may encourage competitors to search for innovative, less harmful ways of production, thus actually increasing well-being.<sup>53</sup> Trying to develop a long term vision, in the 1970's and 1980's of the 20<sup>th</sup> century, the Chicago school advanced a hypothesis which saw the development of common law as a steady evolution toward efficiency.<sup>54</sup> However, empirical time-series studies have already produced evidence that does not sustain this hypothesis in the commercial area.<sup>55</sup>

With regard to the development of a dynamic theory, New Institutional Economics has set foot on a much firmer ground. The theory is built on a model of institutional change, which New Institutionalists see primarily as an incremental process, though change in a discontinuous manner is not excluded, either.<sup>56</sup> In the model, law is no longer some exogenous, human addition to the market, the latter appearing as an ever-existing divine creation. On the contrary, both law and the market are institutions which, set in a larger and complex institutional environment, evolve together, each exerting pressure on the other and affecting its

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Comparative Economics school have been subjected to fierce criticism from the legal community. Using statistical methods, the Legal Origins strand of New Comparative Economics seeks to assert a clear link between the origins of a jurisdiction's legal system, on one side, and, on the other side, the content and enforcement of its legal rules, as well as its economic performance. The large-scale studies offer far-reaching conclusions that do not discriminate between origin and recipient countries or between the ways in which legal transplantation has taken place (involuntary imposition, voluntary emulation, *etc.*). That is, although on the face the Legal Origins theory recognises the importance of institutions for economic growth, it seems to proceed on the basis of the assumption that the disparate institutional environment makes no difference with regard to the effects of transplanted legal institutions. The Institutional Possibilities Frontier strand of the same school also does not engage in a disciplined comparative institutional analysis. It does not analyse the pros and cons of judge-made law, self-regulation and market solutions in developing countries but refers only to the disadvantages of public regulation, jumping to the conclusion that efficiency requires developing jurisdictions to employ less regulation. In this sense and for a more detailed methodological critique of New Comparative Economics, see Antonina Bakardjieva Engelbrekt, 'Toward an Institutional Approach to Comparative Economic Law' in Antonina Bakardjieva Engelbrekt and Joakim Nergelius (eds), *New Directions in Comparative Law* (First edn, Cheltenham: Edward Elgar 2009). For studies from the Legal Origins strand, see Rafael La Porta and others, 'Legal Determinants of External Finance' (1997) 52 *Journal of Finance* 1131; Rafael La Porta and others, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113; Rafael La Porta and others, 'The Quality of Government' (1999) 15 *Journal of Law, Economics and Organization* 222; Rafael La Porta and others, 'Judicial Checks and Balances' (2004) 112 *Journal of Political Economy* 445. For studies from the Institutional Possibilities Frontier strand, see Simeon Djankov and others, 'The New Comparative Economics' (2003) 31 *Journal of Comparative Economics* 595.

<sup>52</sup> Coase regrets that the static framework of neoclassical economics never underwent the transformation experienced by evolutionary biology after Darwin, though for his theory he had also drawn inspiration from Adam Smith. Coase, 'The New Institutional Economics'.

<sup>53</sup> Stefan Grundmann, 'Transaction Costs and Economic Theory' in Stefan Grundmann, Hans-W. Micklitz and Moritz Renner (eds), *Grand Theories of Private Law* (forthcoming).

<sup>54</sup> Posner, *Economic Analysis of Law*; see also Priest; Rubin.

<sup>55</sup> For example, a study based on a data set of 461 US state court appellate decisions, issued from 1970 to 2005 and involving the economic loss rule in construction disputes, the law did not converge to any stable resting point and evolved differently in different states. See Anthony Niblett, Richard Posner and Andrei Shleifer, 'The Evolution of a Legal Rule' (2010) 39 *Journal of Legal Studies* 325.

<sup>56</sup> North, *Institutions, Institutional Change and Economic Performance* 6.

development.<sup>57</sup> In contrast with the neoclassical vision which pictures a relentless advancement toward a stable efficient equilibrium, New Institutionalists tell a much more sophisticated story of change, in which convergence and divergence follow in a complex fashion. While North does not deny that some convergence can be observed within the Western industrial world, he shows convincingly that, even in this case, national stories of evolution diverge, with the gap growing sharply when the analysis is extended beyond these limits.<sup>58</sup> He explains the general process of convergence as a movement toward efficiency. Yet, he acknowledges simultaneously that worldwide inefficient property rights structures abound (with competitive pressures not eliminating them) and societies vary greatly in their economic performance. He rationalises this puzzling – from the mainstream viewpoint – observation with the constraining nature of institutions, which condition organisations' choices, incentivising behaviour that in fact perpetuates the existing institutional structure. The way to understand the process of institutional stability and change as well as the convergent/divergent evolution of institutions across jurisdictions is to retrace the historical context in which national institutional matrixes have grown.<sup>59</sup>

North's observations on convergence and divergence between countries' economic performance do not radically differ from the convergence/divergence tendencies perceived by comparative lawyers. Rethinking comparative law classifications, more and more often they emphasise the so-called Western legal tradition, which, despite the important differences between the encompassed common law and civil law jurisdictions, is considered roughly homogeneous.<sup>60</sup> New Institutional Economics forces lawyers to recognise that introducing a new legal solution means expending scarce resources and thus does away with any traces of economic nirvana that may be left in comparative law.<sup>61</sup> But what is more important, by exploring the kind of conditions that account for institutional change toward (in)efficiency across time, the historical branch of the New Institutional school can greatly enrich comparative research on legal transplants.<sup>62</sup> This is essential considering that despite having collected abounding evidence on

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<sup>57</sup> The use of institutional theory by New Comparative Economics is flawed in this respect too. In the studies of the Legal Origins strand, legal origin is viewed as exogenous – transplanted through conquest or colonisation. Under the assumption that the development of a legal system cannot be linked to a country's political and economic environment, legal origin is used as an instrumental variable to test the claim that legal rules systematically affect economic performance. The questionable rigid exogeneity of legal systems, the omission of changes in legal rules and different legal influences over time make extremely problematic any decisive conclusions about an existing consistent causal relationship between the common law/civil law distinction and economic outcomes. In this sense, see Simon Deakin, *Law and Economic Growth* (Presentation, European University Institute March 2011).

<sup>58</sup> North, *Institutions, Institutional Change and Economic Performance* 6, 130.

<sup>59</sup> Ibid Preface, 6-7, 73-82.

<sup>60</sup> Mattei 95, 224-226; Pier Giuseppe Monateri, 'Methods in Comparative Law: an Intellectual Overview' in Pier Giuseppe Monateri (ed), *Methods of Comparative Law* (First edn, Cheltenham: Edward Elgar Publishing 2012) 10.

<sup>61</sup> It has been asserted that the positivistic perspective of domestic lawyers is supported by the neoclassical economic nirvana, in which consistency of the hierarchical system of legal norms, is achieved without any limitations on rationality and transaction costs. Nicita and Pagano; Fabrizio Cafaggi, Antonio Nicita and Ugo Pagano, 'Law, Economics, and Institutional Complexity. An Introduction' in Fabrizio Cafaggi, Antonio Nicita and Ugo Pagano (eds), *Legal Orderings and Economic Institutions* (First edn, London and New York: Routledge 2007) 1-2. The comparative scholarship on legal irritants and legal fragmentation, however, implies some understanding of the constraints, termed by economists as transaction costs and bounded rationality. Günther Teubner, 'Legal Irritants: Good Faith in British Law, or How Unifying Law Ends Up in New Divergences' in Francis Snyder (ed), *The Europeanisation of Law: the Legal Effects of European Integration* (First edn, Oxford: Hart Publishing 2000). Yet, to the extent some lawyers still automatically equate borrowing and harmonisation with the introduction of the "best" solution, even comparative analysis has not completely broken free from economic nirvana assumptions.

<sup>62</sup> New Comparative Economics is convincingly criticised with respect to the necessary conditions it identified for successful legal change. It has been submitted that the effect of transplanted legal solutions is determined to a greater extent by the degree of their domestication, achieved in the receiving country, rather than by the legal

the occurrence of legal change, comparativists know very little about its causal factors, to which they continue to refer only by the vague notion of prestige.<sup>63</sup>

In examining history, the concepts of path dependency and institutional complementarity become crucial for understanding long-run legal and economic change. The increasing returns of past institutional choices underpin the evolution of legal institutions and markets on a particular path and reversal of direction often comes only through changes in the polity or technological shocks.<sup>64</sup> From this perspective, the very mode of change (*e.g.* choice of regulation by contract law or by administrative intervention) may be determined by a strong path dependency. On one hand, such dependency enables predictions about the probable response of a legal system to a new challenge in conditions of continuity; on the other hand, it influences the effects generated by a new legal rule in a particular jurisdiction.<sup>65</sup> In addition, the choice of one type of institutional arrangement in the economic domain makes a fitting institution viable in the legal domain and vice versa. Such institutional complementarities create the possibility for multiple self-perpetuating equilibria, all of which may be equally optimal, but may also result in a Pareto-inferior outcome.<sup>66</sup> Therefore, convergence of legal systems toward efficiency is possible but in no way guaranteed, and divergences may mean inefficiencies but this is not necessarily so.<sup>67</sup> Different equally efficient or inefficient development trajectories are also feasible. Thus, emphasising the local historical conditions and the interdependence between the legal and economic domains, New Institutional Economics rejects the universal evolutionary path of law envisaged by the Chicago school. Instead, it provides a framework to analyse legal change which allows for a trend of convergence but also accounts for the diversity of national laws and for the dissimilar ways transplanted legal solutions play out in different legal systems.<sup>68</sup>

The different analytical procedure (i), the view of the market as not efficient in itself (ii) and the development of convincing theory explaining change over time (iii) constitute real methodological differences between the Chicago school and New Institutional Economics which ultimately translate into a different stance with regard to the concept of efficiency. In neoclassical theory efficiency is understood as the ideal solution in the Kaldor-Hicks sense, which can be brought about by the free market and with which common law comports. New Institutional Economics, on the other hand, does not have such an absolute view of efficiency. It is not obsessed with the idea of devising the ideal solution. It rather looks for the second-best but feasible solution which is to be chosen from the set of identified, functionally equivalent alternatives according to the level and types of transaction costs. Transaction costs themselves depend on the institutional environment in which the alternative options are

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family from which they were borrowed. Daniel Berkowitz, Katarina Pistor and Jean-François Richard, 'Economic Development, Legality and the Transplant Effect' (2003) 47 *European Economic Review* 165; Daniel Berkowitz, Katarina Pistor and Richard Jean-François, 'The Transplant Effect' (2003) 51 *American Journal of Comparative Law* 163.

<sup>63</sup> In this sense, see Alan Watson, 'Comparative Law and Legal Change' (1978) 37 *Cambridge Law Journal* 313, 320; Mattei 129.

<sup>64</sup> North, *Institutions, Institutional Change and Economic Performance* 112.

<sup>65</sup> Ugo Mattei and Fabrizio Cafaggi, 'Comparative Law and Economics' in Peter Newman (ed), *New Palgrave Dictionary of Economics and the Law*, vol 1 (London: Macmillan Reference 1998) 348-349.

<sup>66</sup> Masahiko Aoki, *Toward a Comparative Institutional Analysis* (First edn, Cambridge, Massachusetts; London: MIT Press 2001). For a formal definition of institutional complementarity, see Ugo Pagano, 'Legal Positions and Institutional Complementarities' in Fabrizio Cafaggi, Antonio Nicita and Ugo Pagano (eds), *Legal Orderings and Economic Institutions* (First edn, London and New York: Routledge 2005) 65-66.

<sup>67</sup> In the same sense, see Mattei, *Comparative Law and Economics* 129, 133-134.

<sup>68</sup> See in this sense Nicita and Pagano.

embedded.<sup>69</sup> Efficiency, thus, becomes a relative, dynamic notion, not equated with the unique, optimal state of the world to which law, in the Chicagoan vision, is bound to converge in the long run. Efficiency is contingent on the institutional framework, the latter in turn determined by the historical path on which it has evolved.

It is this context-dependent, dynamic concept of efficiency embraced by comparative law and economics<sup>70</sup> that lays the foundation of refined, empirically relevant economic analysis. Such understanding of efficiency implies that for the same legal problem one contract remedy may turn out to be efficient in one legal system and inefficient in another or that different contract remedies may prove to be equally efficient in different national laws.<sup>71</sup> Consequently, with regard to any normative recommendations, efficiency is viewed as a category which is to be implemented in different ways in the different legal systems.<sup>72</sup> Having clarified the choice of economic methodology and the controversial issue of efficiency from a theoretical perspective, I now turn to the important role of comparative law in the proposed interdisciplinary approach.

### C. The Role of Comparative Law

As both New Institutional Economics and comparative law employ the comparative technique and the functional method of comparison, they naturally merge in the comparative law and economics approach. In the past comparative lawyers have often slipped into merely descriptive exercises in which they observe similarities and differences between legal systems without providing convincing theoretical explanations for them. From this point of view, comparative law can gain from the mature economic framework, providing it with a possibility to rationalise better the collected evidence as well as to measure more accurately the common core and the dissimilarities between national laws.<sup>73</sup> Also, unlike lawyers in the common law tradition, who master inductive analysis, economists tend to engage in deductive thinking: on the basis of certain assumptions they construct models which they then test against empirical data in order to draw conclusions.<sup>74</sup> In this sense, legal scholars can benefit from economic reasoning which forces them to understand and make explicit their own systemic assumptions about law. No doubt, starting from abstract legal norms and overarching principles, civil lawyers are accustomed to deductive analysis.<sup>75</sup> This, however, does not mean that they are proficient in spelling out their premises. On the contrary, largely determined by legal tradition, these premises are often taken for granted and thus remain tacit in the reasoning of civil lawyers. In addition, the increase in legislation of technical character as well as in the standing of the judiciary progressively stimulates inductive legal thinking in civil law jurisdictions. Thus, continental legal scholars can also take a lesson from economists in clarifying their presuppositions when searching for the correct answer to a problem.

Economic analysis enriches comparative law; yet, the latter's contribution to law and economics should also not be underestimated. Comparative law provides abundant empirical data, thus enhancing realism in economic analysis. It bears rich knowledge about the legal

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<sup>69</sup> Oliver Williamson, *The Mechanisms of Governance* (First edn, New York: Oxford University Press 1996).

<sup>70</sup> Mattei, *Comparative Law and Economics*; Mattei and Cafaggi, 'Comparative Law and Economics'.

<sup>71</sup> Paraphrased from Mattei and Cafaggi, 'Comparative Law and Economics' 347. See in the same sense Mattei, *Comparative Law and Economics* 133-134.

<sup>72</sup> In a similar sense, see Mattei, *Comparative Law and Economics* 22.

<sup>73</sup> In this sense, see Mattei and Cafaggi, 'Comparative Law and Economics' 346-347; Mattei, *Comparative Law and Economics* 97, 124-125.

<sup>74</sup> Mercuro and Medema 41-43.

<sup>75</sup> Konrad Zweigert and Hein Kötz, *Introduction to comparative law* (Third rev. edn, Oxford: Clarendon Press; New York: Oxford University Press 1998) 69.

orders integrating the different legal solutions and, hence, of the variables affecting transaction costs. Last but not least, comparative law surmounts the difficulties arising from the different source-of-law structure in common law and civil law legal systems.

### *1. Abundant Empirical Material*

Comparative law brings in an inexhaustible pool of alternative legal solutions to economic problems, making economics less abstract, more engaged with the real world and simultaneously more capable of generalising about the working of law, not as local background but as universal social phenomenon.<sup>76</sup>

Opening the door to an abundant variety of existing property rights structures, none of which matches the natural law model, comparative law shows the necessity of moving beyond the unrealistic template on which mainstream law and economics bases its analysis.<sup>77</sup> Appreciation of the wide range of "jural relations" (rights, liberties, powers, immunities, duties, liabilities and disabilities)<sup>78</sup> will permit a better understanding of the reasons for which legal systems have different combinations of remedies, allow different leeway for judges in awarding them and employ a different model (centralised or decentralised) for remedial distribution.<sup>79</sup>

Yet, the merger with comparative law is also about surpassing the wisdom received from New Institutional Economics. The economic nirvana of zero transaction costs,<sup>80</sup> which New Institutionalists manage to overcome, depends on a "legal nirvana",<sup>81</sup> sustained by the Kelsenian view of law as a united, hierarchical system of legal norms, whose frictionless consistency is derived from the authority of one single source.<sup>82</sup> This legal nirvana has not yet faded away in new institutional research as the latter continues to assume well-defined, tradable property rights over all valued attributes of goods and services, for which rights there always exists a market and an enforcement system, producing efficient resolution to economic conflicts.<sup>83</sup> New institutionalist economists simply take the system of setting and enforcing property rights as given. In their analysis, the interrelationship between transaction governance and law does not affect the level of transaction costs.<sup>84</sup> That is why, the conjugation with comparative law can be especially insightful. With its interest in many, simultaneously valid legal orders comparative law naturally rejects the legal nirvana. In one stroke, it also cures the

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<sup>76</sup> In this sense, see Mattei and Cafaggi, 'Comparative Law and Economics' 346, 348; Mattei, *Comparative Law and Economics* 27-28, 70.

<sup>77</sup> On the natural law misconception of neoclassical law and economics, see *supra* Section B.2.

<sup>78</sup> Daniel Cole and Peter Grossman, 'The Meaning of Property "Rights": Law vs. Economics' (2002) 78 *Land Economics* 317.

<sup>79</sup> Mattei, *Comparative Law and Economics* 58, 63-67.

<sup>80</sup> On the economic nirvana of Chicagoan law and economics, see *supra* Section B.1.

<sup>81</sup> Nicita and Pagano; Cafaggi, Nicita and Pagano 1-2. The authors convincingly illuminate the way in which the economic and the legal nirvana feed and depend on each other. On one hand, the zero-transaction-cost world hinges on the assumption of frictionless, consistent legal system, enforced by fully rational actors. On the other hand, the positivistic legal vision ignores any constraints resulting from scarcity of resources, bounded rationality, transaction costs. See also *supra* footnote 63.

<sup>82</sup> Hans Kelsen, *General Theory of Law and State* (New York: Russel and Russel 1961).

<sup>83</sup> Nicita and Pagano; Cafaggi, Nicita and Pagano 1-2.

<sup>84</sup> For an example of disregarding the influence of law, see Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. For the importance of uncovering the relationship between economic systems and law, technology, culture, see Coase, 'The New Institutional Economics' 74.

home country bias, inherited from American legal scholars working in law and economics.<sup>85</sup> The ample variety of legal arrangements brought in by comparative law in a way confirms, on one hand, their importance for determining the *ex ante* and *ex post* transaction costs and, on the other hand, the problem of using one single legal system as a background for drawing fundamental conclusions on the effect of legal institutions.

## 2. Knowledge of the Legal Systems in Which Legal Rules are Embedded

Economic tools can be applied to any legal system and it is a matter of comparative knowledge, not of *a priori* economic impotence, to factor the different legal solutions across jurisdictions in the analysis. The functional method<sup>86</sup> allows comparativists to pierce the legal systems' doctrinal veil, which obstructs understanding of the way legal rules operate. Carried out on the basis of factual scenarios, functional comparison ignores the conceptual disparities between national laws and identifies the applicable legal rules solving the same problems in each legal system. Such a functional exercise enables, for example, detection of similarities and differences across jurisdictions regarding the available type of remedy and the calculation of damages. It can also penetrate possible differences in legal taxonomies such as contract/tort, public/private law in order to analyse the effect of legal rules on individual behaviour. Yet, the transaction cost analysis will be impoverished if the work remains at the stage of functional comparison and completely disregards the differences in the conceptual frameworks.<sup>87</sup> Once the legal solutions that are functional substitutes across jurisdictions are identified, the relative efficiency of each of them will become clear only by juxtaposing them within the context of each of the selected legal systems. At this point the specific taxonomic and conceptual structures become important again since they can turn out to be sources of transaction costs that have to be taken into consideration.

From this perspective comparative law has accumulated a tremendous amount of knowledge that can help in distinguishing the real and false differences between common law and civil law countries, between the US and European jurisdictions and between the different systems on the Continent. It has much to say about the diverse legal traditions and the possible hurdles generated by them that may preclude legal change in the direction of efficiency.<sup>88</sup> Translated in economic terminology such hurdles constitute *ex ante* transaction costs in the definition of property rights, an issue on which economic analysis has made very little progress.<sup>89</sup> Comparative law can also explain the reasons for which functionally equivalent legal solutions may prove to be grounded in contract in one legal system and in tort in another. It can illuminate the diverse allocation of institutional roles across jurisdictions and thus justify the different weight attributed to private law and public law devices. The different nature of the legal arrangements and the transaction costs imposed by legal tradition may suggest a

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<sup>85</sup> On the home country bias, see *supra* the text accompanying footnote 41 in Section B.2. Instead of correcting this bias, legal scholars, who introduced law and economics in Europe, supported it by not making any adjustments to the particular legal context. On the need to do away with legal positivism in law and economics, see Mattei, *Comparative Law and Economics* Chapter 3 The Distinction between Common Law and Civil Law: Doing Away with Legal Positivism 69-99.

<sup>86</sup> Zweigert and Kötz 34.

<sup>87</sup> For arguments in favour of purposes and concepts going hand in hand in the comparison of legal rules, see also James Gordley, 'The Functional Method' in Pier Giuseppe Monateri (ed), *Methods of Comparative Law* (First edn, Cheltenham: Edward Elgar Publishing 2012) 110-114. In reality, despite the good results the functional method produces, more often than not, comparative legal scholars supplement it with another approach (historical, philosophical, etc.) depending on the focus of their research. Vernon Valentine Palmer, 'From Leretholi to Lando: Some Examples of Comparative Law Methodology' (2004) 4 *Global Jurist Frontiers* 1, 23-24.

<sup>88</sup> Mattei, *Comparative Law and Economics* 77, 141.

<sup>89</sup> In this sense, see Cafaggi, Nicita and Pagano 6.

modification within the existing legal solution without changing its assignment between different areas (contract or tort, private or public law).<sup>90</sup> Comparative research also implies that the development of a legal system may strongly depend on the degree of influence of the professional groups framing the law in the different legal contexts. Hence, determined by factors such as power and authority, the evolution of the legal system may not necessarily entail cuts in transaction costs.<sup>91</sup> All these are matters which must be investigated on a case-by-case basis. However, what needs to be emphasised at this stage is that methodologically comparative law has a great deal of experience in the deconstruction of the declared legal rules as well as in the deep-level examination of the context-dependent conceptual framework.<sup>92</sup> Both are vital for making a sound economic analysis.

### 3. Bridging Source-of-Law Differences

While enabling economic analysis to account for local particularities, comparative law is also able to bridge the common law/civil law divide where the latter is irrelevant for law and economics. Nowhere is this more evident than in the question of the sources of law recognised in common law and civil law jurisdictions.

According to traditional accounts, the source-of-law structure is a key difference between common law and civil law systems: the former mostly based on judge-made law, applied according to the rule of precedent, while the latter - grounded on statutory law, interpreted by courts. On the face, this raises a problem – where law and economics focuses predominantly on case-law, the analysis can be *a priori* attacked as unconvincing. After all, even if having some influence in legal reality, case-law in civil law systems is not setting out binding legal rules. Thus, the absence of a rule of precedent gives rise to concerns over whether the economic approach is at all fit to be applied to civil law. Clearly such a view is the legacy of the positivist conceptions of law, ignoring the latest achievements of comparative law methodology.<sup>93</sup>

Inherently anti-positivist in nature, comparative law has long passed the point of juxtaposing only the legislative texts of European continental legal systems, struggling with the phenomenon of uncodified common law. The focus on law in action has opened new lines of enquiry revealing that the similarities between the two legal traditions are more than previously presumed. Comparativists continuously emphasise that throughout the 20<sup>th</sup> century the common law/civil law differences in the source-of-law structure have been softened with the two legal traditions experiencing a process of convergence. It has long been maintained that common law courts live in "the age of statutes",<sup>94</sup> while legislators in civil law jurisdictions face the reality of increasing case-law impact on the legal system. The role of civil law judges is hardly exhausted with being the "mouthpiece of statutory law", as appealed by Montesquieu. Rather, they have their own lawmaking contributions. Examples can be put forward not only from the jurisdictions that have supplied the grand civil codes (France and Germany) as is usually done, but also from less known civil law countries as Bulgaria. Bulgarian courts have developed important issues of the regime of damages for breach of contract, of the contract for the benefit of third parties, the contract for transfer of property in exchange of care and

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<sup>90</sup> Mattei and Cafaggi, 'Comparative Law and Economics' 348; Mattei, *Comparative Law and Economics* 74.

<sup>91</sup> Mattei, *Comparative Law and Economics* 120-121.

<sup>92</sup> On the formants approach in comparative law, which emphasises the clash between stated and operational rules as well as the importance of the legal discourse, see Monateri 22-24.

<sup>93</sup> In this sense, see Mattei, *Comparative Law and Economics* 69-99.

<sup>94</sup> Guido Calabresi, *A Common Law for the Age of Statutes* (First edn, Cambridge, Massachusetts: Harvard University Press 1982); Patrick Atiyah, 'Common Law and Statute Law' (1985) 48 *Modern Law Review* 1.



maintenance. The court decisions in the area of preliminary contracts have even prompted amendments to the relevant statutory provisions.<sup>95</sup> But even where case-law has not led to statutory amendments, civil law judges participate in lawmaking. Undoubtedly, in all civil law systems the broad standards, used abundantly in the legislative acts ("the reasonable man, etc."), actually increase the importance of case-law, as judges are charged with the task of giving these broad concepts a concrete meaning. And where civil codes cannot keep pace with modern life, judges fill the gaps adapting the law to contemporary reality and thus carrying it a step further. All the amassed comparative experience shows that the differences with regard to the source-of-law structure between civil law and common law are exaggerated and do not preclude economic analysis.

Yet, when tackling the different structure of sources of law, comparative law does not stop with the identification of the trend of convergence between civil law and common law systems. Acknowledging the changing social reality and in an effort to capture law in action, the most recent comparative theory maintains that a specific legal rule cannot be ascertained by solely consulting the source of law (legislation or case-law), endorsed by the national definition of the term. A legal rule is rather a product of the interaction of different "legal formants" (court decisions, legislative acts, scholarly works), each of which contributes to shaping the rule.<sup>96</sup> Thus, finding the rule requires consultation of many different texts, written by different suppliers of law, which may very well contradict and challenge each other. The role of the comparative lawyer then is, by analysing all these texts, to discover not the rule in force, but the true operational rule in the legal system as well as the various factors and influences that led to it. Resolving in this way the puzzle with the different source-of-law structure, comparative law not only manages to overcome the gap between common law and civil law systems and to establish itself as one of the most promising legal disciplines. It also makes it possible to perform an economic analysis which accounts for the dissimilarities between the different legal traditions and simultaneously bridges them in order to examine them from a common perspective.<sup>97</sup>

In other words, just like neoclassical economics is not the mandatory branch of economics to be used, American law (or another common law legal system) does not constitute an obligatory background for economic research. Bringing with it ample empirical material and accrued knowledge of different institutional environments, it opens the economic perspective to the peculiarities of various national contexts. At the same time refuting the natural law and positive law assumptions that still underlie economic theory and solving concrete methodological problems (as in the source-of-law example), comparative law aids law and economics in its universalistic efforts.

The final requirement for a good method for doing law and economics is for reciprocity. Adding the insights from another discipline – economics – opens new horizons to legal research and infuses it with new analytical energy. Yet, true interdisciplinarity cannot be achieved where economics (as in the case of Neoclassical Economics) subjugates law and

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<sup>95</sup> Krasen Stoychev, 'Contracts. Bulgaria' in Roger Blanpain, Michele Colucci and Jacques Herbots (eds), *International Encyclopaedia of Laws*, vol I (First edn, The Hague: Kluwer Law International 1999) 12.

<sup>96</sup> Rodolfo Sacco, 'Legal Formants: A Dynamic Approach to Comparative Law' (1991) 39 *American Journal of Comparative Law* 343. Legal formants may also be referred to in terms of professional communities who are engaged in shaping the law (judges, legislators, professors). John Dawson, *The Oracles of the Law* (Second edn, Westport, Connecticut: Greenwood Press 1978); Raoul van Caenegem, *Judges, Legislators, and Professors: Chapters in European Legal History* (First edn, Cambridge (Cambridgeshire); New York: Cambridge University Press 1987); Monateri.

<sup>97</sup> Mattei, *Comparative Law and Economics* 70-71.

treats it only as an object of research without allowing for the deep internal links between the two disciplines. Interdisciplinary interaction makes sense only if the approaches are combined in a way to enhance each other and create a new method of increased power and insight. On this account, comparative institutional law and economics is a remarkably promising marriage between two methodologies of two different disciplines. Both inherently comparative and historical, New Institutional Economics and comparative law naturally complement each other, curing each other's weaknesses. In the resulting rich framework, efficiency ceases to be a universal benchmark to which all legal systems are measured against and acquires meaning only within the institutional environment of a particular jurisdiction. Capable of such deep-level studying of national legal systems, comparative law and economics can then produce a unifying theory of law as a universal social phenomenon. It is only regrettable that until now this new interdisciplinary field has not been fully explored.

## **Conclusion**

In this paper I claim to have made several contributions. The first is a modest one – it exposes to the legal audience of this journal the availability of a different kind of economics, one that is not so common yet that it is sufficiently well-developed to make important contributions to the analysis of a number of legal phenomena. More importantly, it was shown that New Institutional Economics does not suffer from the shortcomings of the neoclassical approach that make the latter unpalatable for many lawyers. The more ambitious contribution is to propose a development of the NIE method. I have shown that while NIE represents an improved alternative to neoclassical economics, by itself it is not epistemically satisfactory either. Its own limitations, however, do not make it redundant when applied to law. On the contrary, I have shown that it is a natural partner to Comparative Law – an approach which is well-established in legal scholarship. NIE can form an equal partnership with Comparative law – Comparative Institutional Law and Economics as I called it – which promises to be very fruitful both for economics and for law. This will be especially valuable for those of us who want to study law in the full richness of its social context. While Socio-Legal Studies are increasingly popular in the academia, the economics is conspicuously absent from this ‘socio’, as if economics were not a social science. Thus, the furthest reaching goal of this paper is not only to show a proper way to do law and economics, but also to put economics back on the broad palette of socio-legal scholarship. The final contribution which I claim is to have rescued the concept of efficiency from the grip of neoclassical economics. Instead of the universal yardstick that enables the economists to pass judgements on rules, institutions and legal systems that they rarely bother to fully understand, comparative institutional law and economics uses a concept that is dependent on the context. While it allows meaningful comparisons between different institutions within jurisdiction, or between alternative institutions across jurisdictions, it eschews the urge to rank them according to their proximity to a Platonic ideal type.