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A CRITIQUE OF LAW & ECONOMICS –
AN AUSTRIAN SCHOOL PERSPECTIVE

Introduction

The main assumption in economics is that the World is one of limited resources, yet people possess unlimited wants. It seems counterintuitive to view the law as based upon market principles, but undoubtedly one of its main goals is to prevent the emergence of conflict and enable societies to function peacefully. Conflict, however, is inevitable when resources are scarce.¹

Most legal scholars profess that law is concerned primarily with questions of rights, justice and fairness. These concepts, however, are difficult to define with precision² and many legal schools of thought remain under the influence of legal pragmatism. These schools include the school of neopragnatism, critical legal studies, and – above all, emerging from the University of Chicago in the 1960s – the Law & Economics (L&E, also known as the economic analysis of law) movement,³ which applies economic theory and method to the practice of law. As an academic discipline, L&E became popular starting with the works of the Nobel Prize winner Ronald Coase, who created the analytical model for assigning property rights and liability in economic terms. His followers continued the work by scrutinizing legal doctrines through economic analysis. The most famous proponent of L&E, Richard Posner, became known for his many books and articles on law and economics. The L&E school evidently revolutionized first, the American,

then West European legal education. Nowadays, economic principles are commonly used in legal analysis to gain valuable insights.

The purpose of the article is not to explore the relationships between law and economics or to identify the reasons why positivism was especially successful in the social sciences. Further, the purpose is not to organise critic’s claims and L&E’s counterclaims, but to cast some light on the criticism of L&E by the so-called Austrian School, which is perhaps most famous for its economic analysis.

L&E literature is vast, and for this article the relevant component of the literature deals with the following concept: an economic efficiency criterion identifies the desirable content of the law (but – does it?).

The concept of Law & Economics

Instead of looking for unique features of law, L&E looks at it as a convenient social tool, and then tries to evaluate it functionally. In other words, L&E emphasizes the place of the institution of law within the general and common economic structure of society. A normative theory of adjudication was among the earliest claims advanced in the L&E. First of all, the theoretical L&E analysis focuses on the efficiency concept. R. Posner interpreted efficiency as wealth maximization, and also later interpreted this concept as willingness to pay.

The methodological foundations of the L&E school are based on the concept of law as an optimal outcome of a judicial balancing of socio-economical costs and benefits. An efficient system is one that increases the net value of resources. In particular, cost-benefit analysis attempts to implement the so-called Kaldor-Hicks evaluative criterion. According to this criterion, the distribution of goods $X$ is superior to the distribution of goods $Y$, if and only if there exists a third distribution of goods $Z$ such that (a) $Z$ is a redistribution of $X$; and (b) $Z$ is Pareto preferred to $Y$.

When people value some goods higher than others, then economic efficiency can usually be attained through voluntary transfer of these goods (free contractual relationship). In other words, if exchange of goods is allowed, the efficiency of the initial allocation is of secondary importance, because each single resource probably will end up in the hands of the person that values it the most. The Coase Theorem, the most fundamental result

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in the economic study of law, states that if there are no transaction costs (there are no costs of finding anyone with whom a bargain can be struck, there is no artificial barrier to commercial transactions, etc.), the assignment of entitlements will be irrelevant to the goal of allocative efficiency. In such a situation, of course, there will be no need for law to internalize costs, because people will bargain to the most efficient possible allocation of goods.

L&E stresses, quite rightly, that free markets are more efficient than courts. In market economies, property rights are defined efficiently in many circumstances. So, whenever possible, the legal system should force a transaction into the market. Sometimes though, it is not possible and it is the role of a judge to mimic a market and guess at what the parties would have desired if markets had been feasible. In many circumstances, however, who initially owns the right will matter. Transactions costs are seldom zero, and so if rights are imperfectly allocated, a costly transaction will be needed to change this misallocation. Therefore, the enforcement and allocation of legal entitlements are important factors in ensuring economically efficient exchanges. This means that law can be used to encourage economic efficiency and that economic analysis models the results of legal proceedings better than any other theory. In other words, the law is best seen as a tool to optimize contractual arrangements and, first of all, it can help in situations where transaction costs are so high as to prohibit efficient contractual relationships. Outside of conceptually ideal markets there are always transaction costs, such as the cost of information, opportunity, and administrative costs. Here the law can encourage economic efficiency by assigning property rights to those parties who would have secured them through market exchange if transaction costs had been lower. In other words, law should bring about allocations that imitate the results of an ideally functioning market.

Nevertheless, a question arises – might not law be better used to consider issues related to justice, duty and the like? L&E claims that the meanings of words such as justice or duty are so vague that the use of such concepts as a basis of judicial decisions offers no guidance whatsoever. It is argued that while such concepts are unhelpfully complex, the tools of economic analysis and the concept of economic efficiency are sufficiently clear to provide the judge with a solid and predictable basis for decision-making.

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7 Ibidem.
Decisions in law can be made more easily according to efficiency rather than justice or duty due to the limitations of institutional competence. In particular, this might be so if issues of justice are so complex as to involve information that courts are structurally unable to process.

The L&E concept of economic efficiency seems to offer an integral solution in this respect. Specifically, a fair legal system is one that deliberately promotes gains in social welfare. R. Posner considers economics to be a source of insight regarding the cost-benefit properties of alternative legal instruments. These instruments then can be used primarily to lead to higher social efficiency. In other words, the main assumption of L&E is that jurisprudence should transform the limits of traditional property rights in order to get an optimal degree of economic efficiency. The general theory is that law is best viewed as a social tool that promotes economic efficiency and economic analysis, and economic efficiency as an ideal that can guide legal practice.

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Undoubtedly, it was the historical role of the L&E movement to articulate some very interesting assumptions in respect to the concept of interpretation of law. Nevertheless, it seems now that there can be no genuine progress of this school of legal thought unless it proceeds to a fundamental inversion of its logic.

A growing number of scholars have tried to prove that what seems to be the logical consequence of the L&E’s underlying methodology is contradiction of its own terms. In other words, the L&E efficiency theory of rights can be seen not only as flawed, but even nihilistic. The basis of such a critique is rejection of the assumption essential for L&E that an economic criterion is considered as a worthy goal for the functioning of legal institutions.

Until recently, L&E analysis focused primarily on exploring and developing the descriptive aspects of the theory. In other words, this school was interested in the law as a concept. So, the main approach of the L&E was to use standard microeconomic tools in order to explain the logic of

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9 J. Šíma, M. Froněk, op. cit., p. 123.
11 E. Krecké, op. cit., p. 2.
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jurisprudence. Using sophisticated models, this school sought to show the mechanisms by which the law encourages economically efficient social behavior.\(^\text{13}\) Not surprisingly, difficulties emerged. Problems with empirically verifying the descriptive theory of efficiency finally brought about a gradual shift from an explanatory to a normative theory of L&E. In other words, if it is not possible to prove empirically that the system of law is efficient, one can state that this system ought to be efficient. Then, the L&E’s efficiency theory became a normative principle for guiding legal policy.\(^\text{14}\)

The concept of scarcity is a good example. This concept implies – of course – the inevitability of conflict. Somebody wants to use somebody’s else property as one pleases. Who is to be the owner? Is there any rule of law in this respect? Should we really resort to cost-benefit analysis to assign ownership title?\(^\text{15}\)

The L&E theories operate, out of necessity, at a relatively high level of abstraction, including the use of quite sophisticated mathematical models to derive precise quantitative predictions for overall normative assessments. However, such simplifying assumptions seem to create a substantial risk of overlooking essential aspects of the analyzed area of inquiry and may generate predictions of little relevance to the actual circumstances.\(^\text{16}\) Finally, such assumptions leave many important questions unanswered. There’s no need to emphasize that the social sciences have to deal with structures of essential complexity, whose characteristic properties can be exhibited only by models made up of relatively great numbers of variables. As Alan Morrison, Professor of Finance at the Said Business School of the University of Oxford emphasises – mathematics, in excess, blurs our perception of economic and legal institutions.\(^\text{17}\) The emphasis on mathematics is a symptom of a deeper change in the discipline: the robust adoption of what may broadly called *positivism* as a guide for research and the criterion for successful construction of economic and legal theory.\(^\text{18}\) Already in the early

\(^{13}\) E. Krecké, op. cit., p. 3.

\(^{14}\) E. Krecké, op. cit., p. 6.


\(^{17}\) A. D. Morrison, *Rating agencies, regulation and financial market stability* [in:] P. Booth (ed.) *Verdict on the Crash: Causes and Policy Implications*, The Institute of Economic Affairs 2009, s. 120.

nineteenth-century, the French economist Jean-Baptiste Say lamented in his magnum opus A Treatise on Political Economy that people are too apt to suppose that absolute truth is confined to mathematics and to the results of careful observation and experiment in the physical sciences.\textsuperscript{19} Besides, it is crucial to keep in mind that there are many varieties of social analysis. An approach with direct relevance to a particular problem can be often irrelevant to other problems.

Undoubtedly, the Austrian theory provides tools to critically evaluate the basis of the *wealth maximization* approach to law. In particular, this theory is able to prove that the L&E approach finally leads to the conclusion that private property rights are subsidiary to supposed economic efficiency.\textsuperscript{20} In other words, in the L&E perspective, the concept of economic efficiency is the normative criterion that reflects best in an ideal legal system.\textsuperscript{21} Contrary to this perspective, the modern Austrian school approach includes primarily an assumption that a society states a rather complex and dynamic process that is subject to an institutional order that is in continuous evolution. Taking this assumption under consideration, legal rules should be evaluated not through a comparison of equilibrium end-state outcomes, but in accordance with their impact on the process by which individual members of the society can coordinate efforts to achieve their objectives.\textsuperscript{22} Whatever the details of a case, some theory of justice is needed through which to interpret them. From this perspective,\textsuperscript{23} the focus of L&E on the econometric estimation of the various structural parameters seems to be a misdirection of effort.\textsuperscript{24}

Thus, the concept of applying the wealth maximization principle cannot be seriously taken into consideration in a real world context. One cannot expect jurisprudence to precisely weigh and compare any potential efficiency results of its decisions, particularly in the absence of any actual transaction itself. Such a task is plainly impossible.\textsuperscript{25} The legal practitioner must tackle specific cases involving real people who operate in particular times and places. People live in social and cultural contexts with differing sets

\textsuperscript{19} Ibidem, p. 10.
\textsuperscript{20} W. Block, O.J.’s Defense: A Reductio ad Absurdum of the Economics of Ronald Coase and Richard Posner, Loyola University New Orleans 2011, p. 3.
\textsuperscript{21} E. Krecké, op. cit., p. 7.
\textsuperscript{22} G. S. Crespi, op. cit., p. 71.
\textsuperscript{24} G. S. Crespi, op. cit., p. 15.
of assumptions, expectations, and patterns of communicative action as embodied in linguistic and other cultural conventions.\textsuperscript{26} If a justice provider, such as a judge, is to take a fair look at any real case, a complex of possibly messy or apparently contradictory accounts of details may need to be collected and evaluated.\textsuperscript{27}

Even if jurisprudence were in fact attempting to generate pure economic efficiency, it cannot be done since judges must act on the basis of very incomplete knowledge.\textsuperscript{28} Specifically, if a judge is to succeed in attaining the goal of maximization of wealth, he must possess some means for such calculation. Yet the only information he has are existing market prices and this is clearly not sufficient.\textsuperscript{29} Naturally, the complexity of our World is such that to make an attempt to base judicial ruling on economic efficiency data wouldn’t seem serious, let alone just. In the most general sense, there is, indeed, no such thing as an economic future. There is only the future in which economic factors are bound together, inextricably, and quite without hope of separate identification, with the whole universe of forces determining the course of events.\textsuperscript{30}

Herein lies another problem of L&E’s incoherency. L&E analysis is confined to applications of static models that lack some essential features of the real world.\textsuperscript{31} R. Coase established two propositions that have come to define the L&E paradigm. According to his theory, there are two states of analytical circumstances. The first one is characterized by zero transaction costs, which implies that any transaction among society members can be easily and cheaply concluded. The problem is, this state of the world doesn’t seem to exist. The second state is characterized, first of all, by positive transaction costs – and this does resemble reality. Under these circumstances, it is, of course, not easy to rearrange titles to property, particularly when there are numerous buyers or sellers potentially involved. So, finally, transaction costs make commercial activity inefficient in comparison to a world without transaction costs.\textsuperscript{32} That assumption leads the L&E school to accept

\textsuperscript{27} Ibidem, p. 40.
\textsuperscript{28} G. S. Crespi, op. cit., p. 27.
\textsuperscript{30} M. N. Rothbard, op. cit., p. 8.
\textsuperscript{31} E. Krecké, op. cit., p. 7.
that there should be no property rights established prior to consideration of wealth maximization. On the contrary, the accurate function of property rights is to maximize wealth, and the law should be construed so as to bring about this goal.33

In addition, the validity of the L&E model seems to be limited to an unrealistically stationary world. If the claims are of exhaustive descriptive accuracy then it is more than likely a failure. In particular, when L&E scholars emphasize the need of prices for the application of the famous Kaldor-Hicks test, they stress the importance of fixed relative prices.34 On the other hand, Austrian theorists are aware that the concept of economic efficiency is in fact meaningless, since it is based upon the theoretical assumption of stable human preferences and social structures that are unaffected by the decision of a legal ruling.35 The background of the Austrian theory is a world of continuous change in which plans have to be conceived and continually revised.

Clearly, there is no way that jurisprudence can help to decide cases while following the doctrine of wealth maximization.36 Furthermore, the reliance on this principle has some more unwelcome implications. L&E’s principle states that resources should be assigned to those who value them most, i.e., to those who are willing and able to pay for them.37 To assess the individual willingness to pay, cost-benefit analysis simply sums the individual willingness to pay. Second, this analysis has to use a method of interpersonal comparisons of well-being, which require identification of appropriate representation of each individual’s preference, ordering and comparing those representations. Cost-benefit analysis however does not identify representations on moral or political grounds; rather it chooses the representations that contingently arise from the actual distribution of wealth and income in the society.

In simple terms, a legal situation would be economically efficient if a right was given to the party who would be willing to pay the most for it. If the granting of rights is to be based on ability to pay, a problem arises for those who cannot pay. It seems that for L&E theory they simply do not count. As Anthony T. Kronman, a former dean of the Yale Law School, put it: The principle of wealth maximization necessarily favors those who

33 W. Block, op. cit., p. 1.
already have money, or the resources with which to earn it, and are therefore able to pay more than others to have a new legal rule defined in the way that is favorable to them.\textsuperscript{38}

The central problem seems to lie in the interdependence of law and the ethical dimensions of law. For L&E what is right and what is wrong are merely contingent.\textsuperscript{39} A just legal system can hardly be based on the contingent notions of right and wrong. Consequently, efficiency in the L&E meaning is an empty concept.\textsuperscript{40} The concept of economic efficiency leads inevitably to internal incoherence of the L&E methodology and its contradictory conclusions.

An Austrian concept of efficiency in law

The Austrian school also tried to offer a normative assessment of a policy, but this endeavor was not based upon the efficiency characteristics of the resource allocation. Even if efficiency precept considerations implicitly emerge in the Austrian framework, it is far from being a central value in this context. Nevertheless, Austrian reliance on personal and private property rights seems to create a much more robust thesis than the L&E concept of wealth maximization.\textsuperscript{41} The Austrian outlook is based on a traditional understanding of law, so the main assessments focus here on the impact of the policy measure at issue upon the processes through which individual learning and behavioral changes take place over time.\textsuperscript{42} Besides, efficiency has a very different meaning than in the L&E concept. For Austrians, effectiveness grows to the extent that one focuses one’s activities within one’s circle of influence, rather than in the circle of concern, meaning areas one may have an interest in, but over which one is not able to have a direct impact through action.\textsuperscript{43} Thus, the concept of efficiency is not viewed by Austrians as a goal, but rather as an attribute of a just legal system. In the Austrian legal perspective efficiency is a purely relative concept. In other words, this concept per se does not mean anything. There are no intrinsic values; every single value is to be considered as adherent.\textsuperscript{44}

\textsuperscript{39} J. Šima, M. Froněk, op. cit., p. 129.
\textsuperscript{40} E. Krecké, op. cit., p. 9.
\textsuperscript{41} W. Block, O.J.’s Defense:, op. cit., p. 1.
\textsuperscript{42} G. S. Crespi, op. cit., p. 16.
\textsuperscript{43} K. Graf, op. cit., p. 49.
\textsuperscript{44} E. Krecké, op. cit., p. 14.
The Austrian school’s methodology deals with necessary, abstract principles. It can be described in this respect as a process of deducing universal rules from axiomatic propositions. Its focus on the need for actual people’s choices is the source of requirements for jurisprudence to base its rulings upon. Instead of trying to calculate an optimal economic outcome, the Austrian school approach urges judges to try to find a way to resolution by relying more on social norms or the traditional logic of private property and contracts. Finally, the Austrian school contends that there are social laws that cannot be verified or refuted merely by reference to observed data; that such laws should significantly determine the impact of positive law and jurisdiction on the economy. The Austrian scholars claim that the description of these laws should be the subject of a priori legal and economic praxeological theory.

In the Austrian tradition, the law is seen as a social institution, a form of spontaneous order that comes out as public and private individuals interact in their attempts to develop adapted responses to the problems posed by their ignorance and uncertainty. In this perspective, a society’s legal system has no existence apart from the subjective preferences and the conduct of the individuals who constitute that society. In this respect the evolution of such a system is open-ended and unpredictable. As a consequence, the law could not be perfectly efficient. In contrast to L&E, the Austrian school concept of law openly accounts for the imperfections in the legal system without considering the presence of such flaws as a misfortune. In this line of thinking, no ultimate value is advanced whose achievement becomes a central goal for legal institutions.

Austrians hold that social science deals with human action rather than with the objects of human action, such as quantities of goods and services. This approach enunciates the abstract principles of human action and includes the assumption, that those principles are sufficiently general to be usefully applied to a wider range of human interests. Theory and practice are discrete, complementary realms, which must interact and communicate.

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46 J. Šima, The The Logic of Social Action, op. cit., p. 49.
49 J. G. Hülsmann, Editorial, op. cit., p. 3.
50 L. J. Sechrest, Praxeology, op. cit., p. 21.
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if justice is to be achieved in any real case. The principles often described as useful in legal theorizing are not so much those of the Austrian school, but rather a core of praxeological methodology and content that also underpins economics in the Austrian tradition.\textsuperscript{51} What seems to be most important in respect to the methodology of the Austrian school, the consistent application of praxeological reasoning, seems to lead to the same general social system, regardless of whether it is economics or law.\textsuperscript{52} Besides, its methodology allows for a considerate economic understanding of legal phenomena in general.\textsuperscript{53} Indeed, praxeology constitutes methodology that can serve as well as an analytical framework for economics as for legal theory.\textsuperscript{54} Thus, in the Austrian view, justice rather lies within a deductive legal-theory domain, not the “ought” domain of static economic efficiency. Huerta de Soto, Professor of applied economics at Rey Juan Carlos University of Madrid, an Austrian School economist writes of justice that: \textit{What is just cannot be inefficient, nor can what is efficient be unjust. The fact is that, under the perspective of dynamic analysis, equity or justice and efficiency are simply two sides of the same coin... This... not only allows efficiency to be appropriately redefined in dynamic terms, but also throws a great deal of light on the criterion of justice which should prevail in social relations. This criterion is based on the traditional principles of morality which allow individual in accordance with behavior to be judged as just or unjust in general and abstract juridical rules regulating, basically... property rights...}\textsuperscript{55}

Summary

Despite its influence, the L&E movement has been criticized from a number of directions. The most vivid debates on the place of economics in legal reasoning have to do with the notion that justice and equity can never be set against the standard of efficiency. The present article features the concept of economic analyses of law from an Austrian school perspective. Although those two schools bear some resemblance, there are clear-cut differences between them as far as epistemological and methodological questions are concerned.

\textsuperscript{51} K. Graf, op. cit., p. 6.
\textsuperscript{52} L. J. Sechrest, op. cit., p. 21.
\textsuperscript{53} E. Krecké, op. cit., p. 15.
\textsuperscript{54} L. J. Sechrest, op. cit., p. 21.
\textsuperscript{55} K. Graf, op. cit., p. 56.
The Austrian legal theory tries to provide different foundations for an economic analysis of law. The Austrian school describes the law rather as a coordination procedure built on abstract rules of just conduct. The L&E recommends that judges and the law itself should play a principal role in the efficient allocation of property rights. From the Austrian perspective, it is sound legal theory that can serve as the best tool to the legal practitioner. Sound legal theory can provide categorical distinctions and formal sets of descriptive relationships that can then be subjected to moral evaluation for action purposes. In particular, it is praxeological legal theory that supplies some of the underlying questions to which case-specific details shape answers. Legal principles guide inquiry into specifics while emerging details suggest the most relevant set of legal principles to apply.\(^{56}\) In other words, action-based jurisprudence produces internally consistent formulations of the requirements of justice.

The Austrians contend that there are legal objects and laws that exist and can be studied independent of positive legal codes, so there’s specific Austrian \textit{a priori} foundations of analysis. In addition, as to the their analytical praxeological method, the Austrian school stresses the importance of \textit{human action} approach in respect to explaining rights and obligations. Austrian school authors are concerned more with rules of social behavior, which are not the result of positive lawmaking.

Considering law as an efficiency providing mechanism, L&E analysis deliberately proceeds to a reduction of law to this economic goal and to the conviction that ethics is a just arbitrary matter and there is no room for it in legal and economic analysis.\(^{57}\) Challenging the traditional legal concept of causation and then assuming, that economic efficiency remains the only adequate criterion of just law, undoubtedly leads to a final premise, that there is no justice apart from economic efficiency.\(^{58}\)

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\(^{56}\) K. Graf, op. cit., p. 46.
\(^{57}\) E. Krecké, op. cit., p. 6.
\(^{58}\) Ibidem, p. 7.