Chapter 1
An Introduction to Law and Economics

The introductory material in this chapter is very similar to that in previous editions. Most law students will find it either off-putting or suspicious that economists pay so much attention to efficiency and not much to fairness or justice. So, it's worth saying whatever one can early in the semester about this topic. The section on the efficiency aspects of achieving an equitable distribution of resources makes what seems to us to be an uncontroversial point—namely, that in seeking an equitable outcome, one ought to pay attention to efficiency considerations—but it is a point about which there has been much *sturm und drang* in the professional literature. There is more on this issue on our website.

■ Efficiency; Positive and Normative; Ex Ante; and Empirical

Over the years we have found that although law students are becoming increasingly familiar with economic (and other social scientific) concepts, there is, nonetheless, some deep and persistent misunderstandings about economics among noneconomists. One that seems nearly impervious to reasoned refutation is that economics is a handmaiden to a very conservative political philosophy. It may be that there is a sensible explanation for why this view is so widespread, but if so, neither of us has expressed it or heard it.

We have also found that there are some emphases that you might want to make in discussing the material in this chapter. First, be sure to stress the difference between positive and normative analyses. Economic analysis is insightful in both tasks. Even those who are skeptical of efficiency as a legal norm must recognize the value of economic analysis in performing positive analysis.

Second, we have found that stressing the *ex ante* analysis of the effects of legal rules is crucial. This is especially so with regard to law students. Legal education tends to focus on the resolution of disputes. Indeed, in the United States the principal method of teaching any substantive area of the law is to read the opinions of appellate justices. There's no denying the value of this method of teaching the law. But it also has costs. One is that law students tend to focus on how best to resolve disputes than on how best to *avoid* disputes. Law and economics clearly puts a much stronger emphasis on the *prospective* effect of law—that is, on a law's likely effect on future human behavior—than does traditional doctrinal analysis.

Third, we believe that one of the most significant developments in law and economics since the publication of the early editions of this book has been the rapid rise of empirical legal studies. Indeed, there is now a first-rate scholarly journal entitled the *Journal of Empirical Legal Studies*. You might want to alert your students to the fact that this edition of the book, unlike previous editions, now contains, as an integral part of each subject, an extensive discussion of the empirical literature in this area. Preparing the students to think about the empirical aspects of the subject—does the patent system really encourage innovative and inventive activity, and how would we know?—is an important innovative element of law and economics in the legal curriculum.

■ Introduction to Law and Economics

Part of the delight of this course is the reading and discussion of written opinions of courts in some real disputes. The founding article of law and economics—Ronald Coase's, "The Problem of Social Cost," 3 *J. Law & Econ*. 1 (1960)—contained this wonderful case. We'll describe it in some detail because it serves as a wonderful introduction to the subject. Or you might use these facts in an examination or in a later class discussion.

The case of *Sturges v. Bridgman* involves a dispute about the use of property in London in the 1870s. The plaintiff (the person who files a com*plaint*) was a Dr. Sturges. He felt that his neighbor, Mr. Bridgman, had interfered with his legitimate use of his property. Dr. Sturges had built a consulting room at the end of the garden behind his home. As was the custom for doctors then, he held examinations of his patients in that room. Apparently to save money in building the room and to preserve as much of his garden as possible, Dr. Sturges had built the wall of his consulting room hard against the back wall of his neighbor, Mr. Bridgman. Thus, the neighbors shared a wall, which was called a "party wall."

The Bridgmans operated a confectionery-manufacturing operation in their kitchen, and their kitchen wall was also the back wall of Dr. Sturges' consulting room. When the confectionery-manufacturing machines were going, they made such a racket that Dr. Sturges could not properly examine his patients. He brought an action against the Bridgmans to ask the court to order them to stop making so much noise during his office hours. The Bridgmans answered this complaint by saying that they were using their property in a perfectly legitimate manner, and, moreover, they had been doing so for over 60 years without anyone's complaining of noise and vibration. They suggested that the doctor could not fairly claim that he had been surprised by their manufacturing activity. He knew or should have known that they were using noisy machinery when he decided to build his consulting room hard against their kitchen wall.

Here is what the court said about the matter and how they tried to resolve this dispute:

Sturges v. Bridgman
11 Ch.D. 852 (1879)[1]

The Plaintiff in this case was a physician. In the year 1865 he purchased the lease of a house in Wimpole Street, London, which he occupied as his professional residence.

Wimpole Street runs north and south, and is crossed at right angles by Wigmore Street. The Plaintiff's house was on the west side of Wimpole Street, and was the second house from the north side of Wigmore Street. Behind the house was a garden, and in 1873 the Plaintiff erected a consulting-room at the end of his garden.

The Defendant was a confectioner in large business in Wigmore Street. His house was on the north side of Wigmore Street and his kitchen was at the back of his house, and stood on ground which was formerly a garden and abutted on the portion of the Plaintiff's consulting-room and the Defendant's kitchen [abutted] the party-wall. The Defendant had in his kitchen two large marble mortars set in brickwork built up to and against the party-wall which separated his kitchen from the Plaintiff's consulting-room, and worked by two large wooden pestles held in an upright position by horizontal bearers fixed into the party-wall. Those mortars were used for breaking up and pounding loaf-sugar and other hard substances, and for pounding meat.

[1] Recall what this citation means. The report of this case may be found in volume 11 of the Chancery Division, one of the major courts in England, beginning on page 852. The opinion was published in 1879.

The Plaintiff alleged that when the Defendant's pestles and mortars were being used the noise and vibration thereby caused were very great, and were heard and felt in the Plaintiff's consulting-room, and such noise and vibration seriously annoyed and disturbed the Plaintiff, and materially interfered with him in the practice of his profession. In particular the Plaintiff stated that the noise prevented him from examining his patients by auscultation for diseases of the chest. He also found it impossible to engage with effect in any occupation which required thought and attention.

The use of the pestles and mortars varied with the pressure of the Defendant's business, but they were generally used between the hours of 10 a.m. and 1 p.m.

The Plaintiff made several complaints of the annoyance, and ultimately brought this action, in which he claimed an injunction to restrain the Defendant from using the pestles and mortars in such manner as to cause him annoyance.[2]

The Defendant stated in his defense that he and his father had used one of the pestles and mortars in the same place and to the same extent as now for more than sixty years, and that he had used the second pestle and mortar in the same place and to the same extent as now for more than twenty-six years. He alleges that if the Plaintiff had built his consulting-room with a separate wall, and not against the wall of the Defendant's kitchen, he would not have experienced any noise or vibration.

[The trial court focused on a single issue: whether the Bridgmans had acquired a right to create noise and vibration against their neighbors by virtue of having done so continually for 60 years with one mortar and pestle and for 26 years with two. The trial court held that no one can acquire a right to create a nuisance and that, therefore, Dr. Sturges was entitled to an injunction against the Bridgmans. The Bridgmans appealed this judgment to a higher court.]

1879, July 1. THESIGER, L.J., delivered the judgment of the Court (James, Baggallay, and Thesiger, L.JJ.)[3] as follows:

[If the general rule was that the Plaintiff had a right to be free from the noise and vibration being generated from the Defendant's property, this rule] would result in the most serious practical inconveniences, for a man might go—say into the midst of the tanneries of Bermondsey, or into any other locality devoted to a particular trade or manufacture of a noisy or unsavory character, and, by building a private residence upon a vacant piece of land, put a stop to such trade or manufacture altogether. The case also is put of a blacksmith's forge built away from all habitations, but to which, in course of time, habitations approach. We do not think that either of these hypothetical cases presents any real difficulty. As regards the first, it may be answered that whether anything is a nuisance or not is a question to be determined, not merely by an abstract consideration of the thing itself, but in reference to its circumstances … where a locality is devoted to a particular trade or manufacture carried on by the traders or manufacturers in a particular and established manner not constituting a public nuisance, Judges and juries would be justified in finding, and may be trusted to find, that the trade or manufacture so carried on in that locality is not a private or actionable wrong. … It would be on the one hand a very high degree unreasonable and undesirable that there should be a right of action for acts which are not in the present condition of the adjoining land, and possibly never will be any annoyance or inconvenience to either its owner or occupier; and it would be on the other hand in an equally degree unjust, and, from a public point of view, inexpedient that the use and value of the adjoining land should, for all time and under all circumstances, be restricted and diminished by reason of the continuance of acts incapable of physical interruption, and which the law gives no power

[2] An injunction is an order from the court to the defendant requiring him or her to do something or, as here, to refrain from doing something. We shall discuss injunctions at more length in Chapter 5.

[3] The abbreviations mean "Lord Justice" and "Lords Justice."

to prevent. The smith in the case supposed might protect himself by taking a sufficient curtilage[4] to ensure what he does from being at any time an annoyance to his neighbor, but the neighbor himself would be powerless in the matter. Individual cases of hardship may occur in the strict carrying out of the principle upon which we found our judgment, but the negation of the principle would lead even more to individual hardship, and would at the same time produce a prejudicial effect upon the development of land for residential purposes. The Master of the Rolls in the Court below took substantially the same view of the matter as ourselves and granted the relief which the Plaintiff prayed for, and we are of opinion that his order is right and should be affirmed, and that this appeal should be dismissed with costs.

What legal rule did the court propound? What is the implicit price placed on different types of behavior affected by that rule? And is that rule (and its implicit price) efficient?

The court in *Sturges* found for the plaintiff and in so doing said that noise and vibration produced on one person's private property is a nuisance if it causes harm to some other person's use of her private property. Moreover, the nuisance-creator (in this case, the Bridgmans) did not acquire a right to create noise and vibration by having done so without complaint over a long period of time.

As to the implicit price on different types of behavior affected by this rule, note that the court speculated on this matter. It asked whether this rule might induce someone to build a private residence in an area previously devoted to the very smelly operation of tanneries and then to seek an injunction against the continued operation of those tanneries on the ground that they were disturbing the new residents. Or the court suggested that its rule might induce potential nuisance-creators, such as a blacksmith, to purchase large tracts of land around their operations to serve as buffers against harming others. These are valid points, but notice that the court dodges the issue of whether these results, these types of behavior induced by its rules, are desirable. Instead, the court said—as courts frequently do—that it would not speculate on these hypotheticals. Rather, it would prefer to let future courts resolve these issues as future parties brought new circumstances before those courts. (This strategy is frequently referred to as dealing with issues "on a case-by-case basis," rather than by the application of a blanket rule. You might ask the students about the differences between the institutional competencies of legislatures and courts to deal with these broad questions. The general feeling is that legislatures can tackle broader issues than can courts, which must, by and large, confine themselves to the facts before them.)

What about the efficiency of the legal rule in *Sturges*? From an economic standpoint, we are eager to have the legal rule in situations of conflicting uses of property or of nuisance encourage the most productive use of all of the resources involved. In the case of *Sturges v. Bridgman* it is fairly certain that the two conflicting uses—the manufacture of confectionery and the examination of patients—are simply incompatible. One of them will have to cease at its present site and re-locate. The question is which one ought to do this. Presumably the use that should cease is the one that is, all things considered, less valuable. If, for instance, confectionery manufacture is more valuable than the doctor's provision of medical services, the Bridgmans should remain, and Dr. Sturges should go. If the doctor's services are more valuable, then Dr. Sturges should remain, and the Bridgmans should go. (Be sure to contrast this with the way in which the court—typically *any* court—would deal with this matter. It would try to find out who had the prior right or who was inflicting unwarranted harm on whom. Having answered those questions, the court will have resolved the matter legally.)

One way to use this case is to anticipate the discussion of the Coase Theorem in Chapter 4. The discussion that follows shows how this might be done.

[4] "Curtilage" is the land around a house and within an enclosure.

Assuming this to be the economic way to look at issues of conflicting property rights, we are led to ask if the legal rule enunciated in 1879 is efficient. However, as we've seen, the legal rule is not entirely clear. On the one hand, the court may have said that the nuisance-creator should *never* prevail. If that were the rule, we could say that it is not necessarily efficient because it does not allow for the possibility that the nuisance-creator's actions are more valuable than those of the plaintiff. On the other hand, the court may have said that in *this* case only the nuisance-creator (Bridgman) should lose but that in different circumstances he or she might win, depending on the facts. This interpretation is more compatible with our efficient rule that the more valuable use should prevail (and, implicitly, that the more valuable use might sometimes be the plaintiff and sometimes the defendant).

There is a third possibility—that the legal rule in situations like that in *Sturges* does not matter to the efficient use of resources by the confectioner and the doctor. That is, it could be that the more valuable use will prevail *regardless of which rule the court adopts*. This would be the case if the costs to the nuisance-creator and the complainant of concluding a private agreement to limit the nuisance are very low. In those circumstances the amount of the nuisance and the amounts of production by both parties will be efficient, whatever the legal rule. Thus, when the costs of concluding a private agreement are low, whether the law states that the Bridgmans are entitled to create noise and vibration or that Dr. Sturges is entitled to be free from noise and vibration, there will be an efficient amount of the nuisance and an efficient amount of confectionery and of doctor's services.

This remarkable conclusion—which we shall explore in much more detail in Chapter 4—is, of course, the *Coase Theorem*, named after its author, Professor Ronald Coase, in this very article from which *Sturges v. Bridgman* is taken—"The Problem of Social Cost."

To see why this conclusion follows, let us imagine an unlikely but dramatic solution to this nuisance problem in *Sturges*: Dr. Sturges marries the owner of the confectionery factory. As a result, the cost of coordinating the activities of the factory and the doctor become very low. We would confidently expect the couple to coordinate their activities so as to maximize the total profits of the two enterprises—that is, to maximize their combined income, regardless of whether the law would protect the doctor's practice from the noise and vibration from the confectionery.

Rational bargainers facing low bargaining costs will do just as well as a married couple, because they will bargain until they exhaust the possibilities for mutual gain, which occurs when the total profits of the two enterprises are maximized. For example, suppose that the damage suffered by the doctor because of the disruption is $5,000 in lost income and that the cost to the factory of installing less noisy equipment, moving the existing equipment, or adjusting its production schedule so as to eliminate the nuisance to the doctor is $10,000. Assume, furthermore, that the two parties can bargain between themselves at low cost.

How will different rules of law affect this situation? If the rule of law entitles the factory to make as much noise and vibration as it likes, then the factory can create its nuisance with impunity. So, it will go on polluting. The doctor will simply have to suffer $5,000 in losses.

But what if the law gives a right to the doctor to be free from the factory's noise and vibration? One might think that the result of this different assignment of rights would force the factory to spend $10,000 to eliminate its nuisance entirely. But under our assumption of low bargaining costs, that result is unlikely. A mutually beneficial transaction is possible that allows the factory to continue its production and nuisance and also allows the doctor to be compensated for the loss of $5,000 that the noise and vibration inflict. If the factory stops its noise and vibration entirely, then it loses $10,000, and the doctor benefits $5,000. Both will benefit if some alternative can be found that pays the doctor more than his $5,000 in losses but costs the factory less than $10,000. Suppose, for example, that the Bridgmans pay Dr. Sturges $7,500 in exchange for the doctor's waiving his right to be free from the nuisance and allowing the factory to continue to create the noise and vibration. Under this alternative, the doctor is paid $7,500 for putting up with $5,000

in damages, thus enjoying a net profit of $2,500. Similarly, the factory is better off paying $7,500 to the doctor instead of incurring the expense of $10,000 to reduce the noise and vibration. Both parties are better off. So, under the assumption of low bargaining costs, the factory will continue its method and location of production whether the law gives the doctor the right to be free from the nuisance or gives the nuisance-creator the right to emit noise and vibration.

There is a useful, general way to describe these facts: if someone values an asset—whether it be automobiles, wheat, labor, or legal rights—more than its owner, then there is scope for mutual gain by exchange. We may think of the agreement between the doctor and the factory as an exchange of legal rights. The potential gains from exchange are not exhausted unless the total profits from the two enterprises are maximized.

■ Impact of Law and Economics

One of the exciting things to tell the students is that law and economics is having a real impact on how courts decide cases. In a recent article by Professor Carol Rose of the Yale Law School—"Canons of Property Talk, or, Blackstone's Authority," 108 *Yale L.J.* 601 (1998)—these two cases are cited as examples of how law and economics is becoming part of the general language of judges: *Westfarm Assocs. v. Washington Suburban Sanitary Comm'n.*, 66 F.3d 669, 679 (4th Cir. 1995) (discussing "externalities"); and *Gail v. United States*, 58 F.3d 580, 585 n.7 (10th Cir. 1995) (discussing "transaction costs").

The bigger impact of law and economics is clearly on legal scholarship, particularly, but not exclusively, in the United States. Every law student today learns a lot of law and economics in the study of the traditional law school courses. Indeed, one can hardly go through the first semester of an American law school education without hearing about the Coase Theorem in property law, efficient breach of contract in contract law, and the least-cost-avoider in tort law. And the impact of law and economics continues in almost every other course taught in the modern curriculum.

Most law professors today in the United States use law and economics in their research. In fact, some of them are so adept at economic reasoning and the techniques of game theory and econometrics that you would think that they have had formal training in economics—even though most have not.

One could argue—one of us *has*—that this is revolutionizing legal scholarship and legal education. But those contentions are not, perhaps, as important as assuring the students that a knowledge of law and economics is vital to the well-trained lawyer today and essential for those who wish to pursue a scholarly career in the law.

■ Efficiency and Equity

The most startling aspect of law and economics, especially to law students, is the normative contention that law should be efficient. It is good to say something about this matter early on because it is going to be a constant source of discussion throughout the semester or term.

There are two general methods of dealing with this matter. One is to take a temporizing position and say something like this, "Efficiency is important but not necessarily the most important quality of a legal command. Distributional or equitable concerns are, without a doubt, extremely important, and many people feel that, as important as efficiency is, it must play second fiddle to distributional concerns. Presumably even if one believes this, one is also willing to concede that legal decisionmakers should consider efficiency. For example, if we could agree on a distributional goal, we would presumably want to reach it in the most efficient method possible."

The other method is to take a more aggressive position. One might say that the private law adjudication process *ought* to focus on efficiency and not on distribution. Distribution, one might argue, is the province of the democratic process, of the legislature, but not of the judges who resolve private law disputes. This second method of dealing with the matter takes strength from the article by Steven Shavell and Louis Kaplow referenced in a footnote and from their recent book, *Fairness Versus Welfare*, and in the Second Fundamental Theorem of Welfare Economics, which holds that issues of efficiency and equity are, in principle, separable.

■ Law and Economics Moot Court

One of the devices that we have found to be fun and instructive in teaching undergraduates law and economics is to hold a law-and-economics moot court. Typically, we hold the court toward the end of the semester, when the students have a better understanding of the full range of private law and, perhaps, of criminal law. If you are interested in trying this, we urge you to begin thinking about it early because the organization of the exercise takes some effort.

The organizational aspects are three. First, you have to choose and edit suitable cases. You will find some edited cases that we have used on our webpage. Second, you must divide the students into small law firms of three or four, enough so that there are an even number of firms, and pair the firms. We frequently ask each firm to designate one of their members to act as the managing partner so that we can funnel all our paperwork and messages through that one person. Then give each firm a copy of the case and instruct the firm, not each individual, to write a short brief by a certain date and to be prepared for oral argument about one week later. The instructions usually instruct the students that the "Supreme Court of Coseana," which will hear their oral argument, only entertains economic arguments, although they expect all those who appear before them to understand and to be sensitive to the legal constraints. Third, you will need to ask local attorneys, law school faculty colleagues, local judges, and third-year law students to serve in panels of three judges to hear the oral argument. In addition, you will have to prepare for these judges a "bench brief," which summarizes the facts in the case, suggests the economic reasoning that you hope the students will pursue in arguing the cases, and even proposes questions that the judges might want to ask. The judges will almost certainly get into the spirit of the moot court on their own, but you can help direct them toward the economic reasoning you hope that the students will pursue by means of this bench brief.

Our experience has been that the students take this exercise very seriously. Indeed, many of them spend more time on this than on other requirements of the course. Interestingly, the rigors of oral argument and of the brief seem to reveal the student abilities that might not be evident through the usual methods of evaluating student performance.