Economic Efficiency and the Common Law

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Abstract

Do legal rules based on the common law in the U.S. result in economically efficient outcomes? Beginning with Posner and Rubin, a substantial amount of literature supports the hypothesis that there is a natural tendency for common law to evolve over time so as to yield economically efficient court rulings. According to this view, disputants will litigate whenever the existing rules are inefficient. If the rules are efficient then no such incentive exists, in which case the legal rules are affirmed. By respecifying the Rubin model as a two-person, non-cooperative, simultaneous-move game, the analysis presented in this paper appears to support the arguments put forth by Landes, Gould, Tullock, and others that there is a general tendency for the disputants to pursue an out-of-court settlement. The analysis also suggests that it may also be in the litigant’s best interest to negotiate an out-of-court settlement when the legal rules are efficient if the expected net present value of accident and avoidance costs is less than the litigants’ court costs. Finally, it may pay to litigate even when the legal rules are efficient if the expected net present value of accident and avoidance costs is greater than the sum of the litigants’ court costs. (JEL K00, K41, D61, C71, C72)

Introduction

Do legal rules based on the common law in the U.S. result in economically efficient outcomes? The evidence or what there is of it, seems to suggest otherwise. Tullock [1997] noted that while the precise social cost of legal disputes is unknown, it must be substantial and certainly much higher compared to developed economies. Tullock noted that in 1983, the U.S. federal, state, and local spending on civil and criminal justice amounted to almost $40 billion or about $170 per capita. This accounted for about 3 percent of total the U.S. government expenditures. Of this amount, $37 per capita was expended on judicial services [Cooter and Ulen, 1988, p. 478], which “amounts to only a small fraction of the social cost of resolving disputes though the courts, since most of these costs are borne by private parties” [Tullock 1997, p. 45]. Cooter and Ulen [1988] estimated that the labor cost of a full trial was about $400 per hour, not including the cost of court facilities. According to Tullock [1997, p. 52]:

“Since the early 1960’s... the U.S. courts have systematically assaulted the classical law of tort dismantling its twin historic pillars—deterrence and compensation—in favor of notions of societal insurance and risk-spreading and undermining the concept of fault as a doctrinal mechanism for limiting tort liability to substantive tortfeasors. [Huber, 1988; Rowley, 1989]. The abandonment of proximate cause in favor of joint and several liability has fired the engines of the rent-seekers who now specifically target deep pockets. The shift from negligence with contributory negligence to comparative negligence or strict liability has induced a sharp increase in moral hazard as plaintiffs lower their own standards of care and has

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stimulated a sharp increase in tertiary legal costs as the volume of law suits has exploded. The widening of damages to encompass pain and suffering and loss of companionship damages as well as to anticipate harms that have not even occurred has made a mockery of the law and has eliminated a wide range of other viable goods and services from the American market place [Barnes and Stout, 1992, ch. 3].”

Do higher legal costs and resulting economic inefficiencies imply a higher degree of accuracy in the U.S. court rulings? Is the truth better served in the U.S. courts than elsewhere? According to Tullock [1980], the available evidence appears to suggest otherwise. Tullock measured the error rate of the courts by comparing the decisions of two independent decision-making bodies about a given case. According to Tullock [1980, p. 32], if the litigants disagree, then one must be wrong. If both agree, then it is possible that both are wrong. Disagreements between litigants constitute a measure of the courts’ minimum error rate. Kalven and Zeisel [1966] found that while it is not possible to ascertain whether the judges or juries were in error, disagreements occurred in one-fourth of the cases examined. By contrast, Baldwin and McConnville [1979] found that the error rate in England was only about one in eight, suggesting that the common law in the U.S. results in economically less efficient outcomes.

Contrary to this admittedly porous evidence, Posner [1979, 1992] argued that there is a systemic tendency for common law rules to evolve toward economically efficient outcomes. According to Posner, litigants will resort to court rulings more frequently when the existing rules are inefficient and less frequently when the rules are efficient. Once efficient rules have evolved, the incentive for further litigation is reduced.

Posner’s process-oriented justification for common law efficiency is related to the utility-maximizing behavior of rational judges who pursue the same instrumental and consumption objectives as private individuals [Posner, 1993]. Because the judiciary operates on a not-for-profit basis, the salaries of federal judges of the same rank are not functionally related to professional stature or productivity. Instead, judges are motivated by prestige and professional recognition within the legal community [Tullock, 1997, p. 22]. As a result, Posner argued that judges tend to adhere to the principle of stare decisis, in which precedent is binding upon subsequent cases. Stare decisis requires that courts behave impartially and universally when applying the law, and discourages courts “from deciding cases on the basis of propositions that it would be unwilling to apply to all similarly situated disputants” [Tullock, 1997, p. 4].

Rubin [1977] argued that when disputants have an ongoing interest in cases as precedent, then the decision to use the courts to settle disputes and the efficiency of the common law are intimately related. According to Rubin, disputants are likely to resort to litigation whenever the relevant legal rules are inefficient. However, they are less likely to do so when the rules are efficient. Resulting court rulings reduce the likelihood of future litigation and increase the probability that efficient rules will persist. Although Rubin analysis supports Posner’s contention of economic efficiency, this evolution proceeds from the utility-maximizing decisions of the disputants rather than from the wisdom of judges.

However, Rubin’s results are not general. If only one of the disputants has an ongoing interest in cases as precedent, as in the case of insurance companies, then precedent will tend to evolve in favor of that disputant. If neither disputant has an ongoing interest, then the status quo is likely to prevail despite the fact that significant inefficiencies may be absorbed by both parties. This is particularly true whenever high court costs may inhibit litigation.

In contrast to Posner and Rubin, Landes [1971], Gould [1973], and Tullock [1971, 1997] determined that the convergence of the common law to economically efficient outcomes is un-