



**NEW ZEALAND INSTITUTE FOR THE STUDY  
OF COMPETITION AND REGULATION INC.**

**THE ECONOMIC ANALYSIS OF LAW  
IN NEW ZEALAND**

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## ***ABSTRACT***

This paper analyses the place of Law and Economics in legal decision-making in New Zealand and seeks to spur discussion and scholarship in the area of Law and Economics in New Zealand, especially within the legal profession. The paper provides a brief introduction to the Law and Economics discipline, assesses the state of Law and Economics scholarship and its use in the New Zealand legal system. It provides a brief introduction to the fundamental principles of economics, advocates the use of Law and Economics in legal decision-making in New Zealand, discusses the benefits of such use, and outlines applications of economics to law drawing on New Zealand case law. The paper goes on to discuss several criticisms of the discipline and the proper role of economic analysis in the law.

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# THE ECONOMIC ANALYSIS OF LAW IN NEW ZEALAND

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*For the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics<sup>2</sup>*

*Judges who appreciate the economics of legislation and the markets will be good agents as well as honest ones. Good agents reduce the costs of implementing laws. Reduce the cost of anything and you get more<sup>3</sup>*

*Efficiency concerns are only one factor in an assessment of the public interest. But we need to appreciate the economic costs of less efficient solutions<sup>4</sup>*

## **I INTRODUCTION**

To a large number of lawyers and judges, economics seems a social science of little relevance to the legal system. What could the study of economic issues such as unemployment, exchange rates, financial markets and business cycles have to do with legal issues associated with justice, equity and fairness? Further, economics is perceived by many in the legal profession to be an inaccessible and esoteric discipline shrouded in jargon such as “efficiency”, “marginal benefit” and “elasticity”, and riddled with mysterious graphs, diagrams and equations.

However to dismiss or ignore the relevance of economics to the legal system at face value is to forgo the undoubted benefits that the economic analysis of law can bring. Economics as a behavioural science can be used to predict behavioural responses to legal rules and sanctions. The economic approach to the law can facilitate judgments, legal policy and the formulation of legal rules that promote the efficient use of society’s scarce resources. The economic approach to law also

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<sup>2</sup> Oliver Wendell Holmes “The Path of the Law” (1897) 10 Harv L Rev 457, 469.

<sup>3</sup> Frank H Easterbrook “Foreword: The Court and the Economic System” (1984) 98(4) Harv L Rev 4, 60.

provides a neutral analytical framework within which lawyers and judges can analyse legal disputes and issues.

Despite these benefits of utilising Law and Economics, the use of economics in the New Zealand legal system has been sparse, especially when compared with other jurisdictions such as the United States. This paper advocates greater use of economics in New Zealand legal scholarship, legal policy, legal argument before the courts and judicial decision-making. Section II of this paper provides a brief introduction to the Law and Economics discipline, with the aim of de-mystifying Law and Economics. Section III assesses the state of Law and Economics scholarship and its use in the New Zealand legal system. Section IV provides a brief introduction to the fundamental principles of economics. Section V advocates the use of Law and Economics, discusses the benefits of such use, and outlines applications of economics to law. Section VI discusses several criticisms of the discipline, and Section VII discusses the proper role of economic analysis in the law.

The central aim of this paper is to spur discussion and scholarship in the area of Law and Economics in New Zealand, especially within the legal profession.

## ***II WHAT IS LAW AND ECONOMICS?***

This section provides a brief introduction to Law and Economics. First, this section defines Law and Economics. Second, this section presents a brief history of the movement. And lastly the section discusses and differentiates different strands of Law and Economics: “old” and “new” Law and Economics, and “positive” and “normative” Law and Economics.

### ***A Definition***

Black’s Law Dictionary defines “Law and Economics” as “[a] discipline advocating the economic analysis of the law, whereby legal rules are subjected to a cost-benefit analysis to determine whether a change from one legal rule to another

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<sup>4</sup> Sir Ivor Richardson “Address to Inaugural Law and Economics Course” LEANZ Newsletter

will increase or decrease allocative efficiency and social wealth”, while Kaplow and Shavell state that the “[e]conomic analysis of law seeks to answer two basic questions about legal rules. Namely, what are the effects of legal rules on the behaviour of relevant actors? And are these effects of legal rules socially desirable?”.<sup>5</sup> Law and Economics thus provides a scientific and empirical framework within which to analyse the likely effects of legal rules on behaviour, provides a methodology for analysing which rules will lead to efficient outcomes, and can also inform the application of existing legal rules. For example Law and Economics can inform us about which negligence rule will provide efficient incentives for producers and consumers to take reasonable care, which legal sanction will prove effective in deterring potential criminals from perpetrating crimes, and which interpretation of existing statutory rules is most conducive to promoting efficient outcomes. Cooter and Ulen describe the discipline well when they say “[e]conomics has mathematically precise theories (price theory and game theory) and empirically sound methods (statistics and econometrics) of analyzing the effects of prices on behaviour”.<sup>6</sup>

### ***B Brief History***

The Law and Economics movement has a long and venerable history and can be traced as far back as authors such as Smith<sup>7</sup>, Hume<sup>8</sup>, Bentham<sup>9</sup>, Bellamy and Beccaria<sup>10</sup> in the eighteenth century.<sup>11</sup> The modern wave of Law and Economics has its origins in the United States, and in particular at Chicago Law School. Early work

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September 1997 1, 6 [“Inaugural Address”].

<sup>5</sup> Louis Kaplow and Steven Shavell “Economic Analysis of Law” NBER Working Paper 6960 1; This is the definition adopted by the Law and Economics Association of New Zealand on their website: see <[http://www.leanz.org.nz/SITE\\_Default/SITE\\_about/default.asp](http://www.leanz.org.nz/SITE_Default/SITE_about/default.asp)> (last accessed 4 June 2005).

<sup>6</sup> Robert Cooter and Thomas Ulen *Law and Economics* (4 ed, Pearson Addison Wesley, Boston, 2004) 3.

<sup>7</sup> See Adam Smith *The Wealth of Nations: Books I-III* (Penguin Books, London, 1999); Adam Smith *The Wealth of Nations: Books IV-V* (Penguin Books, London, 1999).

<sup>8</sup> See for example David Hume *A Treatise of Human Nature* (2 ed, Clarendon Press, Oxford, 1978); David Hume “Idea of a Perfect Commonwealth” in David Hume (ed) *Essays Moral, Political and Literary* (Longmans, London, 1875).

<sup>9</sup> See for example Jeremy Bentham *An Introduction to the Principles of Morals and Legislation* (Hafner, New York, 1948).

<sup>10</sup> Cesare Beccaria and Richard Bellamy *On Crimes and Punishments and Other Writings* (Cambridge University Press, Cambridge, 1995).

<sup>11</sup> For a fuller treatment of the precursors to the modern law and economics movement see Ejan Mackaay “History of Law and Economics” in Boudewijn Bouckaert and Gerrit De Geest (eds) *Encyclopedia of Law and Economics* (Edward Elgar and University of Ghent, Cheltenham, 2000) 65, 67-68.

by Director at Chicago in the 1940s and 1950s<sup>12</sup>, and leading articles by Coase on social cost<sup>13</sup>, and Calabresi on torts<sup>14</sup> set the stage for other prominent (and prolific) writers such as Posner, Becker and Easterbrook. Several journals devoted to Law and Economics emerged such as the *Journal of Law and Economics* (1958), the *Journal of Legal Studies* (1972), and later the *International Review of Law and Economics* (1981) and the *Journal of Law, Economics, and Organization* (1985). Posner published the first edition of his textbook entitled “Economic Analysis of Law” in 1972 (now in its sixth edition)<sup>15</sup>, while Cooter and Ulen published the first edition of their textbook “Law and Economics” in 1988 (now in its fourth edition).<sup>16</sup> Most, if not all, American Law Schools offer courses in Law and Economics, while most Law School Faculties have staff qualified in both law and economics. Also of testament to the success of Law and Economics in the United States is the appointment of a number of Law and Economics scholars to the United States Bench. Most notably Associate Justice Breyer of the Supreme Court, Judge Posner and Judge Easterbrook of the Court of Appeals for the Seventh Circuit and Judge Calabresi of the Court of Appeals for the Second Circuit.

The real growth period for the Law and Economics movement in the United States was the 1970s and early 1980s. Some now question whether the movement is still growing, and whether Law and Economics has had its heyday.<sup>17</sup> It is true that in the United States Law and Economics is perhaps not growing at the same rate as it once was, however it must be acknowledged that every scholarly movement has its major period of growth, which eventually levels off into a period of consolidation and elaboration. Further at some point every discipline reaches a critical mass. Law and Economics can only occupy a certain percentage of any law journal and the market can only support a given supply of Law and Economics textbooks. Most importantly though, the discipline continues to develop and become more specialised, and to

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<sup>12</sup> See MacKaay, above n 11, 71-72 for a description of Director’s role in reviving the movement at the University of Chicago.

<sup>13</sup> Ronald H Coase “The Problem of Social Cost” (1960) 3 J Law & Econ 1.

<sup>14</sup> Guido Calabresi “Some Thoughts on Risk Distribution and the Law of Torts” (1961) 70 Yale LJ 499.

<sup>15</sup> Richard A Posner *Economic Analysis of Law* (6 ed, Aspen, New York, 2003) [“Economic Analysis of Law”].

<sup>16</sup> Cooter and Ulen, above n 6.

<sup>17</sup> See for example Robert C Ellickson “Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics” (1989) 65 Chi-Kent L Rev 23; Richard A Epstein “Law and Economics: Its Glorious Past and Cloudy Future” (1997) 64 U Chi L Rev 1167.

spread to and grow in new jurisdictions, while more and more different schools of Law and Economics thought and scholarship emerge.<sup>18</sup> Certainly no other “Law and ...” branch of scholarship has had such an impact on the legal system and legal scholarship globally as Law and Economics.<sup>19</sup>

### *C Old and New Law and Economics*

Traditionally economic analysis was only applied in areas of the law that directly implicated economic analysis, such as competition law, tax law, commercial law, regulation, labour law and securities law. In those areas of the law economic analysis is necessary to define statutory terms or answer legal questions. For example economic analysis must be used to define terms such as “market”<sup>20</sup>, “cost”, “benefit” and “efficient”.<sup>21</sup> And economics must also be used to answer questions with economic connotations such as whether a contract “substantially lessening competition”<sup>22</sup> or whether a firm is “taking advantage of market power”.<sup>23</sup> This “old” Law and Economics has been the traditional role of economics in the legal sphere.

However as the reach of economic analysis grew and entered the realm of non-market activity such as marriage and the family<sup>24</sup> Law and Economics scholars, such as Posner, started to apply economic analysis to areas of the law not traditionally associated with the market or market activities. This started with applications to contract<sup>25</sup>, property<sup>26</sup> and tort law<sup>27</sup> and has grown into other areas of the law such as

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<sup>18</sup> Mackaay, above n 11, 80 cites different schools: Chicago Law and Economics, Public Choice Theory, Institutional Law and Economics, Neo-Institutional Law and Economics, Neo-Institutional Law and Economics, and Austrian Law and Economics.

<sup>19</sup> See William M Landes and Richard A Posner “The Influence of Economics of Law: A Quantitative Study” (1993) 35 J Law & Econ 385, 385 [“Influence of Economics of Law”]; “Economic Analysis of Law”, above n 15, 28.

<sup>20</sup> See for example Commerce Act 1986, s 27.

<sup>21</sup> See for example Electricity Industry Reform Act 1998, s 2(1).

<sup>22</sup> Commerce Act 1986, s 27.

<sup>23</sup> Commerce Act 1986, s 36.

<sup>24</sup> See for example Gary S Becker *A Treatise on the Family* (Harvard University Press, Cambridge MA, 1981); See also Gary S Becker *The Economic Approach to Human Behaviour* (University of Chicago Press, Chicago, 1976).

<sup>25</sup> See for example Ian Ayres and Robert Gertner “Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules” (1989) 99 Yale LJ 87; Ian Ayres and Robert Gertner “Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules” (1992) 101 Yale LJ 729; Avery Katz “The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation” (1990) 89 Mich L Rev 215; Forrest Miller “Exemplary Damages in New Zealand: A Law and Economics Analysis” (1997) 3 NZBLQ 228.

criminal law<sup>28</sup>, family law<sup>29</sup>, intellectual property law<sup>30</sup>, constitutional law<sup>31</sup>, international law<sup>32</sup>, the legal process<sup>33</sup>, statute law and statutory interpretation<sup>34</sup>, and immigration and refugee law<sup>35</sup>. Law and Economics scholars have also posited an efficiency theory of the common law<sup>36</sup>, and an economic model to analyse the motives of judges in deciding cases.<sup>37</sup> This “new” Law and Economics has provided valuable insights into many areas of the law previously untouched by economic analysis. However the extension of economic reasoning focused on wealth maximisation and wealth creation to areas such as family law and human rights law has often been controversial. The appropriateness of such an extension will be discussed further below.<sup>38</sup>

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<sup>26</sup> See for example Terry L Anderson and Peter J Hill “The Evolution of Property Rights: A Study of the American West” 18 J Law & Econ 163; Guido Calabresi and A Douglas Melamed “Property Rules, Liability Rules, and Inalienability: One View of the Cathedral” (1972) 85 Harv L Rev 1089; Coase, above n 13;

<sup>27</sup> Steven Shavell “Liability for Harm versus Regulation of Safety (1984) 13 J Legal Stud 357; Gary T Schwartz “Reality in the Economic Analysis of Tort Law: Does Tort Law Really Deter?” (1994) 42 UCLA L Rev 377; Guido Calabresi *The Costs of Accidents: A Legal and Economic Analysis* (Yale University Press, New Haven, 1970); Steven Shavell *An Economic Analysis of Accident Law* (Harvard University Press, Cambridge MA, 1987).

<sup>28</sup> See for example Gary S Becker “Crime and Punishment: An Economic Approach” (1968) 76 J Pol Econ 169; Richard A Posner “An Economic Theory of the Criminal Law” (1985) 85 Colum L Rev 1193; Isaac Ehrlich “Crime, Punishment and the Market for Offences” (1996) 10 J Econ Perspectives 43.

<sup>29</sup> See for example Lloyd Cohen “Marriage, Divorce, and Quasi Rents; or “I Gave Him the Best Years of My Life” (1997) 16 J Legal Stud 267; Michael J Trebilcock and Rosemin Keshvani “The Role of Private Ordering in Family Law: A Law and Economics Perspective” (1991) 41 U Toronto LJ 533; Saul Levmore “Love It or Leave It: Property Rules, Liability Rules, and Exclusivity of Remedies in Partnership and Marriage (1995) 58 Law & Contemp Prob 221.

<sup>30</sup> See for example William M Landes and Richard A Posner “The Economic Analysis of Copyright law” (1989) 18 J Legal Stud 325.

<sup>31</sup> See for example Donald Wittman “Why Democracies Produce Efficient Results” (1987) 97 J Pol Econ 1395; Richard A Posner “The Constitution as an Economic Document” (1987) 56 Geo Wash L Rev 4; Stefan Voigt “Positive Constitutional Economics: A Survey”(1997) 90 Pub Choice 11.

<sup>32</sup> See for example Richard A Posner “Some Economics of International Law: Comment on Conference Papers” (2002) 31 J Legal Stud 321.

<sup>33</sup> See for example Steven Shavell “The Appeals Process as a Means of Error Correction” (1995) 24 J Legal Stud 379.

<sup>34</sup> See for example Mario J Rizzo and Frank S Arnold “An Economic Framework for Statutory Interpretation” (1987) 50 Law & Contemp Prob 165.

<sup>35</sup> See for example Julian L Simon *The Economic Consequences of Immigration* (B Blackwell, Oxford, 1988); George J Borjas *Friends or Strangers: The Impact of Immigrants on the US Economy* (Basic Books, New York, 1990).

<sup>36</sup> See for example Paul H Rubin “Why is the Common Law Efficient?” (1977) 6 J Legal Stud 51; George L Priest “The Common Law Process and the Selection of Efficient Rules” (1977) 6 J Legal Stud 65.

<sup>37</sup> Richard A Posner “What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)” (1993) 3 Supreme Court Economic Review 1.

<sup>38</sup> See Part VII The “Proper” Use of Law and Economics.

### ***D Positive and Normative Law and Economics***

It is important at this stage to distinguish between two discrete strands of Law and Economics: Positive and Normative.

Positive Law and Economics is a descriptive species of Law and Economics. It seeks to describe, predict or explain why and how individuals will respond to different legal rules and incentives. The positive strand is focused on understanding how the legal system operates and its effects.

In contrast Normative Law and Economics advances what rules ought to be in place, and how legal issues ought to be dealt with. Thus the Normative strand is a prescriptive theory of Law and Economics. For example some have made normative statements that the ultimate aim of the common law should be efficiency, and legal rules should be developed so as to promote efficiency. Needless to say the normative strand has been far more controversial than the positive.

### ***III LAW AND ECONOMICS IN NEW ZEALAND***

Given the economic and social reforms New Zealand experienced since 1984 one would have expected New Zealand to be at the forefront of the Law and Economics movement.<sup>39</sup> However somewhat surprisingly New Zealand has been slow to embrace the economic analysis of law. This section seeks to gauge the influence of the movement upon the New Zealand legal profession. While it is hard to gauge the impact of a jurisprudential movement reference to law school curricula, legal scholarship, professional organisations and the use of economic analysis in judicial decisions can all provide clues.

In the United States, the home of the modern Law and Economics movement, nearly all of the top law schools offer Law and Economics courses at both the undergraduate and postgraduate level. However in New Zealand only Victoria University of Wellington Law Faculty offers Law and Economics as an undergraduate

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<sup>39</sup> See “Inaugural Address”, above n 4, 2.

course, while Canterbury University offers a postgraduate course (although this is subject to Faculty approval).<sup>40</sup> In contrast to the Law Schools the Faculties of Economics at Victoria, Canterbury, Auckland and Waikato all offer courses in Law and Economics. While it is positive that so many economics departments offer such courses it is in the Law Schools that future lawyers and judges are trained. It is lawyers and judges who will have the opportunity to shape the legal system and its outcomes by making economics-based arguments in court, and by incorporating economic-based reasoning into judicial decisions. As such it is vital that future lawyers are trained in the economic analysis of the law early on. As Professor Easterbrook (as he then was) states “Law schools and the popular climate may be more important in shaping the ways judges analyse cases and express positions. Law schools transmit legal culture to judges early in their careers, send new views through law clerks, exert an (indirect) influence on the way practicing lawyers view issues, and influence the positions taken in their briefs”.<sup>41</sup> Clearly having only one out of five law schools in New Zealand offering an undergraduate elective Law and Economics course is not a positive sign for the movement in New Zealand.

Scholarly writing in the area of Law and Economics could hardly be called prolific in New Zealand law journals. One issue of the Victoria University of Wellington Law Review has been dedicated to Law and Economics<sup>42</sup>, but apart from this articles focused on Law and Economics have been sparse. A quick search on a legal database revealed only four articles published in New Zealand law journals that had “Law and Economics” as one of their main subjects.<sup>43</sup> Further no textbook has been written in New Zealand with Law and Economics as its main focus, while text books dedicated to other areas of law such as tort and contract largely ignore Law and Economics.<sup>44</sup> The above observations do not provide a definitive survey of Law and

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<sup>40</sup> For the 2005 academic year.

<sup>41</sup> Easterbrook, above n 3, 9.

<sup>42</sup> See (1996) 26 VUWLR 1-141.

<sup>43</sup> The database used was “Linxplus” (<www.lexisnexis.co.nz> (last accessed 11 June 2005)), with the search term “Law and Economics” entered into the “Subject/Summary” field.

<sup>44</sup> For example J F Burrows, Jeremy Finn and Stephen Todd *Law of Contract in New Zealand* (2 ed, Butterworths, Wellington, 2002) only dedicates two pages to the impact of economic theory on contract law: see para 2.1.2; Stephen Todd (ed) *The Law of Torts in New Zealand* (3 ed, Brookers, Wellington, 2001) includes no substantive discussion of the economic analysis of tort law, and in another paper Todd has expressed strong criticism of the economic approach to tort liability: See Stephen Todd “Negligence and Policy” in Paul Rishworth (ed) *The Struggle for Simplicity in the Law: Essays for Lord Cooke of Thorndon* (Butterworths, Wellington, 1997) 105, 108.

Economics scholarship in New Zealand but do demonstrate that Law and Economics scholarship is still in its infancy in this country. One fact that could explain this phenomenon is the lack of Law and Economics taught in New Zealand Law Schools, which in turn generates meagre academic interest in the subject. Further while the trend in the top American Law Schools is to have at least one faculty member with a PhD in economics, this is not the case in New Zealand.

While few articles on Law and Economics have appeared in New Zealand law journals, a not insignificant amount of material has been produced by professional organisations and conferences. In 1990 the New Zealand Law Society held a seminar entitled “Economics and the Law: The Application of Economics in Legal Practice”<sup>45</sup> which included among its leaders current Court of Appeal judge Justice Hammond (then Professor Hammond), while in 1993 a New Zealand Law Conference on Law and Economics was held featuring Professor Trebilcock<sup>46</sup> (Director of the Law and Economics Programme at the University of Toronto Law School) and Sir Ivor Richardson<sup>47</sup> (who soon after became President of the Court of Appeal and is now a Acting Judge of the Supreme Court). In 2001 the New Zealand Institute for the Study of Competition and Regulation held seminars in Auckland and Wellington entitled “Economics for Competition Lawyers and Judges” which included Professor Goldberg of Columbia Law School. In 2002 Law and Economics formed a discrete section of the New Zealand Association of Economists’ Annual Conference.<sup>48</sup>

Perhaps the most significant progress made in New Zealand was the formation of the Law and Economics Association of New Zealand (“LEANZ”) in 1994. LEANZ was formed with the following objectives:<sup>49</sup>

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<sup>45</sup> James A Farmer, Grant Hammond and Kerrin M Vautier *Economics and the Law: The Application of Economics in Legal Practice* (New Zealand Law Society Seminar, December 1990).

<sup>46</sup> Michael J Trebilcock “Lawyers and Economic Consequences: An Introduction to the Economic Approach to Law” in *New Zealand Law Conference Papers* (1993) vol 1, 325.

<sup>47</sup> Sir Ivor Richardson “Lawyers and Economic Consequences: The Law and Economics: Commentary on Paper by Professor Michael Trebilcock” in *New Zealand Law Conference Papers* (1993) vol 1, 351 [“Commentary”].

<sup>48</sup> See *New Zealand Association of Economists Annual Conference Programme* (Wellington, 26-28 June 2002) available at NZAE <<http://www.nzae.org.nz/conferences/2002/CONFERENCE-PROGRAMME-FINAL.PDF>> (last accessed 11 June 2005).

<sup>49</sup> See About LEANZ <[http://www.leanz.org.nz/SITE\\_Default/SITE\\_about/what\\_is\\_LEANZ.asp](http://www.leanz.org.nz/SITE_Default/SITE_about/what_is_LEANZ.asp)> (last accessed 11 June 2005).

- Communicating and disseminating information in New Zealand about law and economics literature and research, and promoting its application to legal and public policy issues in New Zealand and overseas;
- Enhancing understanding of law and economics in New Zealand amongst legal, economic and other relevant professions, including academia, the private sector and government; and
- Fostering teaching, research, publication and education about law and economics in New Zealand.

In the 2001/02 financial year, pursuant to a strategic review, LEANZ undertook the following short term goals:<sup>50</sup>

- General awareness of Law and Economics — identify, disseminate and promote the value that Law and Economics can provide.
- Closing the gaps between lawyers and economists — increasing dialogue between the two groups, increasing mutual recognition of professions.
- Increasing the value of the LEANZ brand — providing value for money for membership including becoming a repository for Law and Economics information and increasing networking opportunities for members.
- Having sufficient resources to meet our objectives.
- Increasing the understanding of economics by the legal community.
- Greater attention to the educational aspects of the objectives.

In general LEANZ has been successful in bringing together lawyers and economists for the purpose of promoting Law and Economics in New Zealand. Of particular value is the Association's website<sup>51</sup>, its links with other professional organisations in New Zealand and abroad, as well as the seminar series it organises every year. The latter has highlighted the views of leading economists, practicing lawyers, judges, politicians and New Zealand and overseas academics. Of particular note is the continued involvement of Professor Epstein of the University of Chicago Law School who has been a key figure in the Law and Economics movement

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<sup>50</sup> See About LEANZ <[http://www.leanz.org.nz/SITE\\_Default/SITE\\_about/what\\_is\\_LEANZ.asp](http://www.leanz.org.nz/SITE_Default/SITE_about/what_is_LEANZ.asp)> (last accessed 11 June 2005).

<sup>51</sup> LEANZ <[www.leanz.org.nz](http://www.leanz.org.nz)> (last accessed 11 June 2005).

internationally, and also the work of Sir Ivor Richardson who is the Association's patron.

Another key indicator of the success of Law and Economics is the use of such reasoning in judicial decisions. As already mentioned above a number of judges in United States Federal courts consistently apply economic analysis in their judgments. However the use of Law and Economics doctrine has been less obvious on the New Zealand Bench with few judges utilising Law and Economics analysis, at least in areas other than competition law. There have been some promising signs: the protagonist of the movement in New Zealand, former President of the New Zealand Court of Appeal Sir Ivor Richardson has promoted Law and Economics outside the courtroom<sup>52</sup>, while a number of his judgments utilise Law and Economics analysis.<sup>53</sup> Other judges, among them Justice Hammond<sup>54</sup> of the Court of Appeal, have shown an interest in Law and Economics and referred to Law and Economics principles in their judgments<sup>55</sup>, however the overall influence that Law and Economics (outside the subject areas of "old" Law and Economics) has had on actual judicial decisions has been limited.

It is hard to measure the influence of a particular jurisprudential movement on judicial decision-making. For instance a judge may subconsciously apply economics-based reasoning so that her judgment has no reference to economics principles yet applies such principles. Further judges may apply Law and Economics analysis

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<sup>52</sup> See for example "Inaugural Address", above n 4; Sir Ivor Richardson "Law and Economics – And Why New Zealand Needs It" (New Zealand Law Conference, Christchurch, October 2001) ["Law and Economics"]; "Commentary", above n 47; Sir Ivor Richardson "Changing Needs for Judicial Decision-making" (1991) 1 J Jud Admin 61 ["Changing Needs for Judicial Decision-making"]; Sir Ivor Richardson "Law and Economics" (1998) 4 NZBLQ 64; Ivor Richardson "Economics and Law: The Courtroom Reality" in *Economics and the Law: The Application of Economics in Legal Practice: Supplementary Papers* (New Zealand Law Society Seminar, December 1990).

<sup>53</sup> See for example *Gartside v Sheffield, Young & Ellis* [1983] NZLR 37, 53 (CA) Richardson J; *Telecom v Commerce Commission* [1992] 3 NZLR 429, 440-447 (CA) Richardson J; *Williams v Attorney-General* [1990] 1 NZLR 646, 681 (CA) Richardson J.

<sup>54</sup> See Grant Hammond "Law and Economics" in Farmer, Hammond and Vautier, above n 45, 1; See the following decisions of Justice Hammond which consider and/or adopt Law and Economics analysis: *Re Newey (deceased)* [1994] 2 NZLR 590, 597 (HC) Hammond J; *Registrar-General of Land v Marshall* [1995] 2 NZLR 189, 197 (HC) Hammond J; *Butler v Countrywide Finance Ltd* [1993] 3 NZLR 623, 632, 635 (HC) Hammond J; *Attorney-General v Udompun* (26 May 2005) CA244/03, paras 206, 214, 222 Hammond J dissenting in part; *Latimer Holdings Ltd v Sea Holdings New Zealand* (15 September 2004) CA214/03, paras 95-96, 103, 122-123 Hammond J for the Court; *Pfizer Inc v Commissioner of Patents* [2005] 1 NZLR 362, para 121 (CA) Hammond J; *Rawlinson v Purnell Jenkison & Roscoe* [1999] 1 NZLR 479, 488 (HC) Hammond J.

consciously yet not use the language of economics, and also not expressly acknowledge the use of economic principles. As such studies that search law reports for key economic terms, as indications of the use of Law and Economics while partially useful can be misleading and unconvincing.<sup>56</sup> Perhaps a better and more telling indicator is the fact that while in the United States judges such as Posner, Easterbrook and Calabresi are renowned for their economic analysis of the law in judicial decisions, New Zealand has no such figure and one would be searching for an extremely long time before finding a New Zealand judge applying a Posnerian cost-benefit analysis to decide a tort case let alone a Bill of Rights case. To me this is simply a flow on effect of the lack of scholarship and learning in the field of Law and Economics among New Zealand law students and qualified lawyers. For example in the United States formal on-going courses in economics are offered to members of the judiciary, however no such scheme has been proposed let alone implemented in New Zealand.

Thus, while Law and Economics has experienced some development in New Zealand, for example the establishment of LEANZ and the leadership of Sir Ivor Richardson, the movement is still in its infancy. Scholarship in the area of Law and Economics is hardly prolific, there has been little judicial application of Law and Economics ideas in judicial decisions, and New Zealand Law Schools have done little to promote learning and academic interest in the area of Law and Economics. Dr Maughan has pointedly commented on New Zealand's unwillingness to adopt Law and Economics stating "[h]ere in New Zealand, sadly, we appear to be clinging to the notion that we have a uniqueness which entitles us to disregard such intellectual development ... I disagree with the notion that there are New Zealand markets that differ from markets anywhere else in the world and ... I disapprove of what looks suspiciously like xenophobia masquerading as caution"<sup>57</sup> while Franks has echoed these sentiments stating "We should not be at a stage of introduction to a now orthodox method of analysis, a thinking discipline and tool without which one can

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<sup>55</sup> See also for example Williams J in *Willis v Castelein* [1993] 3 NZLR 103 (HC).

<sup>56</sup> Two examples of such studies are: Russell Smyth "Law or Economics? An Empirical Investigation into the Influence of Economics on Australian Courts" (2000) 28 Aust Business LR 5; "Influence of Economics of Law", above n 19.

<sup>57</sup> CW Maughan "Economics and the Law" [1994] NZLJ 110, 110.

scarcely participate intelligently in any modern law reform discussion ... for New Zealand lawyers, law and economics is a foreign language”.<sup>58</sup>

#### **IV BRIEF INTRODUCTION TO ECONOMICS**

The starting point for understanding Law and Economics is understanding the fundamental principles that underlie all economic theory. In this regard Sir Ivor Richardson has said “the uneasy relationship between economics and law is likely to improve as lawyers and economists become more familiar with each other’s discipline and the interrelationship of the two fields”.<sup>59</sup>

At its core, economics is the study of how individuals, communities and society at large deal with and manage scarcity. Put simply, economics seeks to discover how economic actors and societies can get the most out of scarce resources with the least waste. It is a study of how and why economic actors make decisions, for example why someone chooses to commit a crime rather than engaging in a lawful activity, and of how economic actors interact, for example how consumers and firms conduct exchange, and transact. It is a discipline steeped in theory and predictive models, and provides an analytical framework and methodology within which to analyse economic (and legal) questions. Of central importance to economics is the use of mathematics, data, and graphical analysis.

Law and Economics draws heavily on microeconomic theory<sup>60</sup>, and it is thus important for any Law and Economics scholar to be familiar with the basic tenets of the microeconomic model.<sup>61</sup> In this section I briefly outline these “fundamentals”. This section seeks to be accessible to those who have not received training in

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<sup>58</sup> Stephen Franks “Lawyers and Economic Consequences: Commentary on Paper by Professor Michael Trebilcock” in *New Zealand Law Conference Papers* (1993) vol 1, 124, 125.

<sup>59</sup> *Telecom v Commerce Commission*, above n 53, 442 Richardson J.

<sup>60</sup> Economics is divided into two main branches: microeconomics and macroeconomics. Microeconomics deals with the behaviour and interactions of individual economics units (such as consumers, workers, investors and producers). Macroeconomics deals with aggregate economic quantities such as the level and growth of GNP, interest rates and unemployment. See Robert S Pindyck and Daniel L Rubinfeld *Microeconomics* (5 ed, Prentice Hall International, New York, 2001) 3.

<sup>61</sup> In the term “microeconomics” I include industrial organisation.

economics, and as such is by no means an exhaustive introduction to the subject of microeconomics.<sup>62</sup>

### ***A Rational Self-Interest and Utility Maximisation***

The basic underlying assumption of all economics is that people are rational self-interested actors. Economic actors are considered to be “rational maximiser[s] of [their] self-interest”.<sup>63</sup> Every economic actor maximises something. People typically maximise their own utility, or happiness, while firms seek to maximise their profits. However because everything in the world is scarce, and thus has an associated price economic actors face constraints. Thus individuals seek to maximise their utility given the constraint imposed by their finite budget. For example a litigious plaintiff could only afford to take X number of lawsuits in any given year given court costs and lawyer fees, despite the fact that they may wish to take more than X cases.

### ***B Trade-offs and Opportunity Cost***

Because everything has a cost, and individuals have a limited budget they face trade-offs. Take the example of a law student facing the decision of what to spend their summer holiday pay on. The student could spend all of her money on law books, or all of her money on social activities such as the movies, or going to dinner. Or the student could spend some portion of her money on textbooks, and the rest on social activities. There is a clear trade-off here: for every textbook she buys the less she can spend on social activities and vice versa.

Closely related to the idea of trade-offs is that of “opportunity cost”, which is the “cost of an alternative that has been foregone”.<sup>64</sup> If someone were considering the

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<sup>62</sup> For a good basic introduction see Pindyck and Rubinfeld, above n 60 and for a more advanced introduction see Andreu Mas-Colell, Michael D Whinston, and Jerry R Green *Microeconomic Theory* (Oxford University Press, New York, 1995).

<sup>63</sup> “Economic Analysis of Law”, above n 15, 4.

<sup>64</sup> Cooter and Ulen, above n 6, 34; It is important to note that “opportunity cost” is not restricted to monetary benefits. A comprehensive definition is given by Peter Newman (ed) *The New Palgrave Dictionary of Economics and the Law* (MacMillan Reference, London, 1998) vol II, 710: “[O]ppportunity cost suggests that something, a course of action, is rejected in order to achieve something else. That which might have been can, of course, never be. Hence, any realization of a foregone opportunity is a logical contradiction. How, then, is opportunity cost measured at all? The

cost of a vacation they would typically add up the cost of travel, accommodation and food involved in holidaying. However an economist would also add the cost of what has been given up by going on holiday. To go on holiday time must be taken off work that may result in lost earnings for the period of the vacation. These lost earnings represent part of the opportunity cost of going on holiday. Thus when we go to the movies we do not simply pay the cost of the ticket and popcorn but also the cost of what else we could be doing with our time.

### ***C Law of Demand***

The Law of Demand holds that if the price of a good increases then, all things being equal, less of that good will be demanded. The amount by which quantity consumed falls relative to a proportional change in price is termed “elasticity”. Elasticity is determined by the availability of substitute goods. For example there are very few alternatives to petrol so that when the price of petrol goes up the quantity consumed remains relatively unchanged. Demand for petrol is thus considered to be “inelastic”. In contrast when the price of a certain brand of breakfast cereal goes up demand will fall given the availability of cheaper substitute brands. Thus demand for cereals is said to be “elastic” relative to the demand for petrol.

### ***D The Invisible Hand, Voluntary Exchange and Equilibrium***

Another fundamental principle of economic theory is that resources will tend toward their most valuable use if economic actors are allowed to voluntarily and freely barter, negotiate and exchange. Voluntary exchange is the quintessential element of an economic market. Those who are willing to pay the most for a good are those who value that good the most. If resources are allowed to gravitate to those who value them the most then the market is running efficiently. Through such repeated

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value of that alternative that might have been chosen but that can never be become quantifiable only in the internal or subjective calculus of the person who makes the relevant choice, and this value exists temporarily only at the moment of the choice itself. Opportunity cost is, therefore, necessarily reckoned in a utility dimension that cannot be observed externally. At best, tolerably acceptable proxies for opportunity cost can be introduced under carefully specified institutional settings ... Because the value of a foregone opportunity is reckoned in a utility rather than a commodity or monetary dimension, non-physical attributes of choice alternatives can readily be entered into the evaluation. The anticipated value of the course of action not chosen may include any attribute that either enhances or retards the intrinsic worth of the ‘thing in itself’”.

interactions between rational self-interested economic agents the market will gravitate towards equilibrium (a point of stability). The classic example of an equilibrium in economics is where the demand for a good exactly equals the supply of that good.

### ***E Efficiency – Pareto and Kaldor-Hicks***

Central to the study of economics is the concept of “efficiency”. Generally speaking efficiency means getting the most out of a given set of resources. However economists have developed a number of different contemplations of efficiency. Here I will deal with Pareto and Kaldor-Hicks efficiency given they are most relevant in the study of Law and Economics.

An allocation of resources is said to be Pareto efficient (or allocatively efficient) if no one can be made better off without making someone else worse off. A Pareto improvement is achieved where a change occurs that makes one person better off without making anyone else worse off.

In contrast to Pareto measures of efficiency, under Kaldor-Hicks efficiency (or a potential Pareto improvement, or as Posner calls it, “wealth-maximisation”<sup>65</sup>) some may be made better off and some worse off as a result of a change. However the change will only be efficient if those made better off gain more than those made worse off lose. In other words if the change results in a net welfare gain the change will be efficient. If this is the case then in theory those who gain can compensate those who lose, although this is not a requirement for efficiency. Kaldor-Hicks efficiency typically entails the use of a cost-benefit analysis to decipher whether a net benefit can be achieved.

Law and Economics scholars, particularly those on the United States Bench, have tended to prefer the Kaldor-Hicks method as a measure of efficiency given it is easier to apply in practice. Also in terms of settling legal disputes it is unlikely that a legal decision could make one party better off without making the other party worse off, and as such it is improbable that a Pareto improvement could ever be achieved by

a legal decision. In contrast the Kaldor-Hicks contemplation of efficiency is less stringent as it allows for one party to be made worse off.

### ***F Marginal Analysis***

Economists think on the margin. They tend to consider the effects of small incremental changes to a set of circumstances, rather than wholesale or aggregate changes. Often decisions involve making small adjustments to an existing plan of action rather than changing the plan in aggregate, and therefore it is rational to consider marginal effects. Key to any economic decision-making is the rule that the marginal benefit of a change must exceed the marginal cost of that change. So for example when deciding how many police to put out on patrol a decision-maker must weigh up, for each additional policeman, the marginal benefit of that extra policeman (for example greater detection of crime and a safer community), and the marginal cost (for example paying the policeman for the time spent patrolling). The more and more policemen placed on patrol, the lower the marginal benefit of the additional policeman because the streets can only be so safe. For example if one hundred policemen are patrolling a small suburb, the benefit of having another policeman will be relatively small. Using marginal analysis a decision-maker can decide upon the optimal number of policemen to have on patrol (achieved when the marginal cost of the extra policeman equals the marginal benefit – for every extra policeman beyond that point marginal cost will exceed marginal benefit resulting in a net loss).

### ***G Incentives Matter***

Because individuals make decisions by comparing the costs and benefits of different options, individuals will generally respond when the costs or benefits associated with one option change making it more, or less favourable. For example if a potential criminal is weighing up whether to engage in a lawful act (for example playing sport) and an unlawful act (for example robbery) the criminal will either consciously or subconsciously weigh up the costs and benefits of those alternative options. Courts and policy-makers could dissuade the criminal from committing the

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<sup>65</sup> See for example “Economic Analysis of Law”, above n 15, 13; Richard A Posner “Utilitarianism,

crime by imposing severe punishments for breaking the law (for example life imprisonment) or increasing the probability that the criminal will be caught and prosecuted (for example increasing police monitoring). By making the commission of the crime more costly the criminal has an incentive to engage in substitute activities.

### ***H Market Failure***

Typically economists trust free markets that are characterised by the above fundamental principles to achieve efficient outcomes. However sometimes markets fail, and such failure can potentially serve as justification for intervention by government, the courts or some other regulatory body.<sup>66</sup> However it must be noted that regulatory bodies can do more harm than good causing greater deadweight losses rather than moving the market towards efficiency. Often regulatory bodies do not have full information and knowledge as to the complexities of the market and are thus not in a position, first to assess the efficiency of the market, and second, to facilitate an efficient outcome. Further regulators may chose to pursue goals other than efficiency that will tend to cause economic losses. This has particular relevance to judicial decision-making, given judges are essentially “regulating” conduct and markets with the rules they create and apply.

One form of market failure that is particularly pertinent and which underlies most other forms of market failure is where markets are characterised by imperfect and asymmetric information. Economists assume that economic actors have complete information about the economic variables that are relevant to the choices they face.<sup>67</sup> If this assumption does not hold true there are implications for measurement, transaction arrangements, market performance and ultimately efficiency. Such informational issues are intrinsic to all exchange: both market and non-market. Much of economists’ time is spent formulating institutional arrangements that best deal with these issues.

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Economics, and Legal Theory” (1979) 8 J Legal Stud 103.

<sup>66</sup> Reasons for market failure include the presence of externalities, public goods, market power and imperfect information; See further Rubinfeld and Pindyck, above n 60, Parts 3-4 for an introduction

<sup>67</sup> See Pindyck and Rubinfeld, above n 60, ch 17.

## ***V THE VALUE OF LAW AND ECONOMICS***

This section discusses the value of the economic analysis of law. The first part of the section considers the benefits of Law and Economics, while the second part outlines various applications of economic principles to and under the law to demonstrate the discipline's usefulness.

### ***A The Benefits of Law and Economics***

The benefits of the economic analysis of law are well established. The two leading textbooks on Law and Economics, by Posner and Cooter and Ulen, do not even deem it necessary to set aside a discrete chapter or section to justify the economic analysis of the law – it is implicitly assumed that the use of the doctrine is beneficial. However given the limited awareness of Law and Economics in New Zealand an elaboration of the benefits of the doctrine is warranted here.

Sir Ivor Richardson has posited that there are two reasons why lawyers should be concerned with modern developments in Law and Economics.<sup>68</sup> The first is that the development and application of legal rules (either through legislation or the common law) necessarily affect the use of society's limited resources. Sir Ivor comments that the efficient use of society's scarce resources cannot, or at least should not, be ignored.<sup>69</sup> The law can be developed, and rules interpreted so as to advance society towards efficient outcomes, thus maximising society's welfare. Economics can inform judges, policy-makers and legislators which rule (or interpretation or application of a rule) among a number of alternative rules (or alternative interpretations or applications of a rule) will best aid the attainment of the efficiency goal.

The second reason Sir Ivor gives is that "like economics, the legal system is concerned with behaviour. It seeks to influence behaviour by establishing rules of conduct and invoking sanctions for their breach".<sup>70</sup> Economic models can predict how individuals and society at large will modify their behaviour in response to legal rules,

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<sup>68</sup> "Law and Economics", above n 52, paras 1-4.

<sup>69</sup> "Law and Economics", above n 52, para 2.

<sup>70</sup> "Law and Economics", above n 52, para 3.

thus informing judges, policy-makers and legislators what effects different legal rules will have. This aids the selection of effective and efficient rules. As Sir Ivor says “we need to understand how people make decisions if we want to change their behavioural response to legal change”<sup>71</sup> while Easterbrook states “[s]etting out to influence future conduct is not very useful unless you know how people respond to incentives ... When the Court misses these marginal effects, the rules it designs may have unanticipated or perverse consequences”.<sup>72</sup> It is important to understand that the Judge is guardian of future interests: By setting rules today that will influence behaviour in the future, the Courts must be aware of not just the interests of the parties before them in any given case but also the interests of all of those affected by the legal determination. In this regard Easterbrook has said: “The principles laid down today will influence whether similar parties will be in similar situations tomorrow. Indeed, judges who look at cases merely as occasions for the fair apportionment of gains and losses almost invariably ensure that there will be fewer gains and more losses tomorrow”.<sup>73</sup>

A further benefit of Law and Economics is that it provides a neutral normative framework within which to analyse legal questions. The use of principles such as justice, equity and fairness, whilst well intentioned and central to the legal system, are inherently subjective and their application is open to arbitrariness. Law and Economics provides a scientific methodology for solving legal questions. The neutrality and objectiveness of economic principles and decisional criteria such as efficiency, costs and benefits, marginal analysis and the law of demand mean that there is less scope for subjectivity to enter legal analysis. On this point Posner has said “[c]onsiderations of the just distribution of wealth or other “justice” factors on which a social consensus is lacking would introduce an unacceptable degree of subjectivity and uncertainty into the judicial process”.<sup>74</sup> Law and Economics can lead to more consistent and principled decision-making: “Administrators and judges need coherent

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<sup>71</sup> “Law and Economics”, above n 52, para 4.

<sup>72</sup> Easterbrook, above n 3, 12-13.

<sup>73</sup> Easterbrook, above n 3, 10-11.

<sup>74</sup> Richard A Posner “Some Uses and Abuses of Economics in Law” (1979) 46(2) U Chic L Rev 281, 292 [“Uses and Abuses”].

standards against which to judge the merits of individual cases. A market-type model provides such standards”.<sup>75</sup>

Also of value in economics is its grounding in empirical evidence. Statistics and empirical facts can often make for better decision-making criteria than sole reliance on intuitions or informed guesses. Sir Ivor has commented on the importance of empirical analysis: “Regrettably there is very little published empirical research and analysis of our laws and their administration. It is much easier to rely on and to engage in intuitive reasoning in drawing conclusions, rather than to get out on the ground and try to ascertain what happens in practice and to explore the costs and benefits of legal rules and administrative approaches. But empirical analysis is important. It is crucial in any public policy analysis”.<sup>76</sup>

Further, on a practical level lawyers and judges need to know economics to be able to effectively discharge their functions. For example in competition law proceedings lawyers “must be able to translate economic language into clear English and to relate it to the case at hand”<sup>77</sup> and judges must be able to intelligibly scrutinise and question expert testimony on economic issues.<sup>78</sup> Lawyers and judges must be able to spot flawed economic reasoning and decide when and when not economics may be relevant to their task.<sup>79</sup>

Professor Grant Hammond (as he then was) has given five more general reasons why lawyers should be concerned with other disciplines:<sup>80</sup>

1. Practicality: Sometimes concepts drawn from other disciplines are embedded in the law itself (for example “monopoly” or “predatory pricing”), and a technical understanding of these terms is required.
2. Complexity of legal systems and legal ordering: Modern statutes increasingly deal with complex subject matter (for example financial policy, competition

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<sup>75</sup> Stephen Breyer “Economics for Lawyers and Judges” (1983) 33 J Legal Educ 294, 296.

<sup>76</sup> “Inaugural Address”, above n 4, 1.

<sup>77</sup> Breyer, above n 75, 301.

<sup>78</sup> Edward R Becker “The Uses of “Law and Economics” by Judges” (1983) 33 J Legal Educ 306, 308: “the judge is the one who must decide that issue, and if the [economic] expert’s opinion is just too untrustworthy or his assumptions are unsupported, speculative, or demonstrably incorrect, then his opinion can be ruled inadmissible”.

<sup>79</sup> See Breyer, above n 75, 305.

<sup>80</sup> Hammond, above n 54, 1.

and telecommunications) and are themselves increasingly complex. Lawyers must seek to understand the wider context within which these statutes are intended to operate so as to fully understand Parliament's intent in passing such laws.

3. Choices: Lawyers are increasingly called upon to advise how choices should be made between competing public policy considerations. To give such advice lawyers will oft require technical knowledge of a wide range of disciplines.
4. Critical analysis: Other disciplines can "provide a deeper perspective on the idea of law, the framework in which it exists, and commentary on particular rules, how they work in practice, and what that *really* means for clients".<sup>81</sup> Thus other disciplines can aid the understanding of the law and serve to critique the law so as to enhance it.
5. Subject matter of the law is life: Because the law on a general level addresses life, the law must remain relevant and valuable by basing itself on all we know about humanity and human activity. Knowledge of other disciplines can help to enrich the law in this way.

### ***B Some Uses of Law and Economics***

This section considers a number of examples from New Zealand case law where Law and Economics analysis has been applied. The purpose of this section is to illustrate the way in which economic analysis can be successfully integrated into legal decision-making in a range of different areas of the law. Specific areas of the law considered here are: torts, intellectual property, Bill of Rights and torts liability, and company law.

#### *1 Torts: Negligence*

In *Gartside v Sheffield, Young & Ellis* the Court of Appeal considered whether a solicitor who had accepted instructions to prepare a will for a client owed a duty to take reasonable care to a beneficiary under the proposed will to carry out those instructions with due diligence and present the will for execution by the client within

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<sup>81</sup> Hammond, above n 54, 1.

a reasonable time.<sup>82</sup> Unanimously the Court held that the case should not be struck out and that a duty of care was present in such a situation.

Of interest is Richardson J's discussion of the policy arguments for imposing such a duty of care in negligence. Richardson J utilised law and economics analysis by placing emphasis on the incentive effects of imposing a duty of care upon lawyers, and discussing what the most appropriate loss allocation mechanism would be in cases of this kind. He said that the recognition of a duty in this class of case served two social objectives: to compensate deserving plaintiffs and to promote professional competence.

In regard to the first objective of compensating deserving plaintiffs Richardson J discussed the loss allocation function of imposing a duty saying:<sup>83</sup>

Beneficiaries designated under a proposed will are not ordinarily able to protect their own interests and in the absence of a right of action have to absorb the costs to them of the negligence of the solicitor. In so far as an action in negligence may be viewed in social terms as a loss allocation mechanism there is much force in the argument that the costs of carelessness on the part of the solicitor causing foreseeable loss to innocent third parties should in such a case be borne by the professionals concerned for whom it is a business risk against which they can protect themselves by professional negligence insurance and so spread the risk, rather than be borne by the hapless individual third party.

In regard to the second objective of promoting professional competence Richardson J had regard to incentive effects, saying that the potential sanction of a negligence suit will provide an incentive for lawyers to conform their conduct to a standard of reasonable care.<sup>84</sup>

Richardson J again had regard to Law and Economics analysis in the context of negligence in *Williams v Attorney-General*.<sup>85</sup> Richardson J noted that the Court was not referred to any Law and Economics analyses of the potential effects on behaviour in cost benefit terms of imposing a duty of care in regard to certain customs legislation.<sup>86</sup> Richardson J said:<sup>87</sup>

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<sup>82</sup> *Gartside v Sheffield, Young & Ellis*, above n 53.

<sup>83</sup> *Gartside v Sheffield, Young & Ellis*, above n 53, 51 Richardson J.

<sup>84</sup> *Gartside v Sheffield, Young & Ellis*, above n 53, 51 Richardson J.

<sup>85</sup> *Williams v Attorney-General*, above n 53.

<sup>86</sup> *Williams v Attorney-General*, above n 53, 681 Richardson J.

Efficiency concerns may need to be weighed with fairness considerations, but it ought always to be important in policy analysis to assess all direct and indirect effects where and to the extent that that is possible. In a case of this kind I consider that the Court should be furnished with arguments and available analytical material so that proposed policy alternatives are considered in an informed way rather than resting on instinctive responses supported by generalised reasons. However, in the absence of any expert evidence or other material of that kind, and recognising that the onus rests on those who advocate the imposition of a duty of care in tort, I have preferred to focus on the change in the historical character of customs legislation.

Richardson J's comments not only highlight the important role economic analysis can play in judicial decision-making but also the key role of counsel in presenting Law and Economics based arguments to the Court. He has echoed this need for counsel to present such analysis to the Court extra-judicially.<sup>88</sup>

## *2 Intellectual property: Patents*

In *Pfizer Inc v Commissioner of Patents* the Court of Appeal considered Pfizer's claim that it was no longer the law that a method of treatment of disease or illness in human beings was not patentable.<sup>89</sup> The Court of Appeal held unanimously that Pfizer's contention failed.

Hammond J in a separate judgment integrated economic analysis in his general discussion of patenting medical treatment.

He discussed the monopoly aspects of patents. Hammond J cited as one of the objections to allowing patenting of medical methods of treatment that if granted, a patent (which is equivalent to a monopoly) would "enabl[e] patentees to exact unreasonable payments for lifesaving or potentially lifesaving techniques".<sup>90</sup> Hammond J was there referring to the monopoly rents that can be reaped by

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<sup>87</sup> *Williams v Attorney-General*, above n 53, 681 Richardson J.

<sup>88</sup> See "Law and Economics", above n 52, para 66; See also "Changing Needs for Judicial Decision-making", above n 52, 65-67 where Richardson comments on the lack of Law and Economics analysis presented to the courts by lawyers.

<sup>89</sup> *Pfizer Inc v Commissioner of Patents*, above n 54.

<sup>90</sup> *Pfizer Inc v Commissioner of Patents*, above n 54, para 113 Hammond J.

monopolists, particularly when there is a complete lack of substitute goods (ie the absence of another treatment that can cure the ailment). Hammond J, in rejecting Pfizer's contention, went on to say that "[i]ndeed the consequence of extending patent protection to what amounts to protection of information about how to use a drug would intuitively be very anti-competitive".<sup>91</sup>

Hammond J also discussed the incentive effects of allowing treatment methods to be patented: on the one hand was the encouragement of research and innovation which would be achieved by patent incentives, and on the other hand were the adverse effects of granting a monopoly in those methods of treatment.<sup>92</sup> Hammond J, later in his judgment, noted the large financial investments that pharmaceutical companies make into developing wonder drugs: "the research leading to a patent is very expensive".<sup>93</sup> He acknowledged the economic realities of the pharmaceutical industry that often the costs of testing and introducing alternatives are also extremely high so that, from the point of view of the competitor, the production costs will outweigh the practicable selling price which inhibits the search for alternatives.<sup>94</sup> He also noted the complication that in an extremely price sensitive industry such as medicine, there will almost always be political intervention in some form.<sup>95</sup> His discussion was also informed by the law and economics literature on patents.<sup>96</sup>

Hammond J's awareness and application of market conditions, incentive effects and the economic principles associated with competition law served to both inform and strengthen his judgment. Without an awareness of such factors a Judge could potentially issue a judgment that created perverse incentives so as to stymie innovation or a judgment that allowed excessive monopoly rents to be exacted. Further a judgment made in a vacuum, without an awareness of market conditions, could easily cause market failure and inefficiency meaning both the industry and consumers would lose.

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<sup>91</sup> *Pfizer Inc v Commissioner of Patents*, above n 54, para 133 Hammond J.

<sup>92</sup> *Pfizer Inc v Commissioner of Patents*, above n 54, para 112 Hammond J.

<sup>93</sup> *Pfizer Inc v Commissioner of Patents*, above n 54, para 121 Hammond J.

<sup>94</sup> *Pfizer Inc v Commissioner of Patents*, above n 54, para 121 Hammond J.

<sup>95</sup> *Pfizer Inc v Commissioner of Patents*, above n 54, para 121 Hammond J.

<sup>96</sup> He cited Edmund W Kitch "The Nature and Function of the Patent System" (1977) 20 J L & Econ 256 and William M Landes and Richard A Posner *The Economic Structure of Intellectual Property Law* (Harvard University Press, Cambridge MA, 2003); See *Pfizer Inc v Commissioner of Patents*, above n 54, para 121 Hammond J.

### 3 Liability: Bill of Rights and torts damages

In *Attorney-General v Udompun* the Court of Appeal considered a claim for compensation under the New Zealand Bill of Rights Act 1990 (“NZBORA”).<sup>97</sup> The Court by a majority of 4-1 reduced the award in the High Court from \$50,000 to \$4,000. Hammond J, dissenting in part, would have awarded \$10,000.

Hammond J’s judgment is notable because of its application of economic analysis to human rights and NZBORA compensation. Hammond J considered that the “remedial approach of treating damages as very much a last resort, and on a “liability” type basis, is ... conceptually inappropriate in a BORA regime”.<sup>98</sup> He employed the analysis of Calabresi and Melamed in their article “Property Rules, Liability Rules, Inalienability: One View of the Cathedral”<sup>99</sup>, saying that s 23(5) of the NZBORA<sup>100</sup> should be seen as an “inalienability” provision.<sup>101</sup> An inalienable entitlement is one that cannot be traded or given up in some if not all circumstances.<sup>102</sup> As such Hammond J said that in considering compensation for a human rights breach, damages cannot be assessed by reference to orthodox common law principles given the inalienable nature of the right at stake.<sup>103</sup> In line with this analysis Hammond J posited that “[t]he inherent dignity of human beings is a “merit” good. It is not a tradable private right. To the extent that compensation is awarded, that compensation should therefore, in principle, be of a “superliability” character”.<sup>104</sup> Hammond J’s characterisation of a human right as a merit good is an innovative and interesting one: a merit good is one that is considered to be intrinsically desirable yet is underprovided (or not provided at all) by the market. As such one could say that regulation of such a good by statute and by the courts is warranted in economic terms.

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<sup>97</sup> *Attorney-General v Udompun*, above n 54.

<sup>98</sup> *Attorney-General v Udompun*, above n 54, para 206 Hammond J.

<sup>99</sup> Calabresi and Melamed, above n 54.

<sup>100</sup> That provision provides: “Everyone deprived of liberty shall be treated with humanity and with respect for the inherent dignity of the person”.

<sup>101</sup> *Attorney-General v Udompun*, above n 54, para 206 Hammond J.

<sup>102</sup> See Calabresi and Melamed, above n 26, 1092-1093.

<sup>103</sup> *Attorney-General v Udompun*, above n 54, paras 206, 214 Hammond J.

<sup>104</sup> *Attorney-General v Udompun*, above n 54, para 214 Hammond J.

Hammond J brought economic analysis to bear in his analysis of costs awards in human rights cases, again referring to the Calabresi and Melamed analysis and also noting incentive effects:<sup>105</sup>

Conceptually, costs are today seen as a form of remedy. In my view, the plaintiff in this case should have her (reasonable) indemnity costs. Again, the Calabresi distinction resonates with me. It is a mistake to think of this as a “liability” situation. What the Court is concerned with here is upholding the “inalienability” of certain kinds of BORA values. The allocation of costs should reflect that recognition. When a citizen - or for that matter a non-citizen - establishes (as here) a distinct and serious breach of BORA by a relevant agency of the state, that agency should be expected to stand fully behind the claim, in costs.

In principle, BORA should not be watered down by leaving persons with no incentive or an inability to bring proceedings.

Law and economics can also be of assistance in deciding upon liability rules in other areas of the law such as tort. Liability rules can be formulated and structured so as to create efficient incentives for economic actors, leading to an efficient level of precaution. For example, assuming perfect compensation, a rule of no liability will give the potential injurer no incentive to take precaution, while a rule of strict liability will cause the injurer to internalise the marginal costs and benefits of precaution, which gives him or her incentives for efficient precaution.<sup>106</sup> If only the victim can take precaution, then a rule of no liability provides incentives for efficient precaution, while if only the injurer can take precaution, then a rule of strict liability with perfect compensation provides incentives for efficient precaution.<sup>107</sup> If both the victim and the injurer can take precaution then other forms of liability rule such as negligence, negligence with a contributory negligence defence, negligence with a comparative negligence defence, and strict liability with a defence of contributory negligence will produce efficient precaution.<sup>108</sup> Cooter and Ulen describe the economic operation of the negligence rules in the following way: “Assume perfect compensation and each legal standard equal to the efficient level of precaution. Under every form of the

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<sup>105</sup> *Attorney-General v Udombun*, above n 54, paras 222-223 Hammond J.

<sup>106</sup> Cooter and Ulen, above n 6, 324.

<sup>107</sup> Cooter and Ulen, above n 6, 325.

<sup>108</sup> See Cooter and Ulen, above n 6, 325-331.

negligence rule, *one* of the parties can escape bearing the cost of harm by satisfying the legal standard. This party will take efficient precaution in order to avoid the cost of harm. The *other* party will, consequently, internalize the cost of the harm from accidents, which creates incentives for efficient precaution”.<sup>109</sup> Thus economics can be used to create liability rules that encourage economic actors to take an efficient level of precaution, and which ensure the burden of precaution is born by the party/parties who can invest in such precaution at the least cost. Such rules promote efficient outcomes.

#### *4 Company law*

Law and Economics analysis is particularly useful in the regulation of market based activities. In *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd* was an “oppression” proceeding brought by minority shareholders in a listed company, Trans Tasman Ltd, against the majority shareholder, SEA Holdings Ltd.<sup>110</sup> The appellants sought relief under section 174 of the Companies Act 1993, colloquially known as the “oppression” provision. The appellants sought an order that SEA be required to purchase their shares at what they asserted to be their net asset value. Williams J in the High Court had dismissed a strike out application made by SEA, but entered summary judgment against the minority shareholders on the basis that the oppression cause of action could not succeed. On appeal, Hammond J for the Court dismissed the appeal saying that Wild J “was not in error in taking the course he did”.<sup>111</sup>

In discussing the development of the legal tests for oppression, and in his discussion of the case before the Court, Hammond J referred to empirical data, incentive effects, game theory and the operation of the market.

Hammond J considered a number of empirical studies from Australia, Canada and the United Kingdom to determine the manner and the circumstances in which resort to oppression-type provisions has been had.<sup>112</sup> He cited these empirical studies

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<sup>109</sup> Cooter and Ulen, above n 6, 330.

<sup>110</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54.

<sup>111</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, para 9 Hammond J for the Court.

<sup>112</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, paras 74-82 Hammond J for the Court.

in order to demonstrate that undue resort is being had to such provisions, and that the legal tests to be applied are not sufficiently certain.<sup>113</sup> Recourse to such empirical studies adds great weight to Hammond J's analysis as it gives concrete evidence for his propositions. The use of empirical studies in this way leads to more informed and credible decision-making than simply relying on assertions and inferences.

Hammond J also showed an awareness of the incentive effects the judgment would have for directors and companies, ensuring that the decision would not produce perverse incentives in the market:<sup>114</sup>

The House of Lords must be right that there should not be a right to exit at will. But in economic terms, the danger is that a restrictive approach may involve senior executives and directors avoiding smaller companies out of a fear of being unduly locked in. And the same issue arises in relation to listed company investment. What is ultimately raised here are significant economic questions, such as the desirability or otherwise of leveraged buy-outs; the proper extent of reasonable shareholder expectations in a given jurisdiction; and the degree to which courts should today review a company's business decisions.

Hammond J also had regard to game theory discussing both exit strategies and litigation strategies. Hammond J said that there exist certain considerations which will make it more difficult for plaintiffs to succeed under section 174 in the case of listed companies. One of these considerations was that the exit strategy for an investor in a listed company, as an alternative to litigation, is to sell his or her shares.<sup>115</sup> He said that there is a continuous market in the shares of listed companies (save in the extraordinary situation where a market becomes illiquid). Hammond J said that such an "exit strategy is more cost effective than litigation".<sup>116</sup> Hammond J did however note that a shareholder may, in a company which is being run in a manner that is prejudicial to its members, face a share price which has fallen before the shareholder decides to, or can, liquidate his or her investment.

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<sup>113</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, para 74 Hammond J for the Court.

<sup>114</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, para 95 Hammond J for the Court.

<sup>115</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, para 103 Hammond J for the Court.

<sup>116</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, para 103 Hammond J for the Court.

In regard to bringing proceedings under oppression provisions Hammond J said that such proceedings can be “strategic” in nature.<sup>117</sup> He said the bringing of proceedings can be designed to bring pressure to bear on a company, or to impose reputational costs on a company.<sup>118</sup> His discussion was consistent with the economics of litigation and settlement bargaining: especially when potential costs and damages associated with litigation as well as the probabilities of winning and losing are factored in, litigation and settlement bargaining can be viewed as an economic game where each litigant acts strategically to achieve the best outcome for themselves.<sup>119</sup>

Finally, Hammond J also expressed the view that the appellants should not be allowed to achieve through the courts, and through legal proceedings that which could not be achieved through the market.<sup>120</sup> He further said that “Shareholding involves risk, and the market must be allowed to reflect that risk”.<sup>121</sup> In taking such an approach, and expressing such a view Hammond J was acting consistently with the approach taken by Easterbrook in his well known article “Foreword”: that the court is a regulator and where possible should not intervene in the operation of the market except so as to correct market failure.<sup>122</sup> Unwarranted and ill-considered governmental and judicial intervention in the market can cause huge efficiency losses.

The New Zealand case law examples demonstrate the value of utilising economic analysis and principles in judicial decision-making. The application of economics in the legal sphere serves to enhance the credibility and robustness of decision-making, promote efficient incentives, and provide a neutral normative framework for decision-makers to operate within. The examples also show that law and economics analysis is able to be successfully applied in everyday decision-making and to real-world issues.

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<sup>117</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, para 84 Hammond J for the Court.

<sup>118</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, para 84 Hammond J for the Court.

<sup>119</sup> See for example Cooter and Ulen, above n 6, ch 10.

<sup>120</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, para 122 Hammond J for the Court.

<sup>121</sup> *Latimer Holdings Ltd v SEA Holdings New Zealand Ltd*, above n 54, para 123 Hammond J for the Court.

<sup>122</sup> Easterbrook, above n 3, 4.

## ***VI CRITIQUES: A DISCUSSION***

A weakness among some Law and Economics scholars has been their reluctance to address critiques of the Law and Economics movement. For example Posner in his Law and Economics textbook dedicates roughly only five out of 716 pages to criticism of the doctrine<sup>123</sup>, while no part of Cooter and Ulen's text specifically deals with criticism. A failure to answer or acknowledge criticism discredits the movement, rather than enhancing it. An acceptance of legitimate criticism, and the encouragement of critical thinking can only serve to strengthen a doctrine, and can pinpoint areas that need strengthening or further elaboration or explanation. In fact it is critical thought that generally stimulates academic interest, debate and scholarship.

In this section I raise and discuss several critiques that have been levelled at the Law and Economics movement.

### ***A The Rationality Assumption***

A number of commentators have criticised the central assumption of Law and Economics that individuals are self-interested utility-maximising actors that act rationally, respond to incentives and have stable and ordered preferences. For example Kelman has criticised this assumption of rationality on the basis that preferences change over time and "there is no a priori reason to assume intertemporal consistency of desire".<sup>124</sup> Kelman posits that neoclassical theory does "not cope at all with regretted choices or ambivalence", "choices made under more or less constraint or duress", or "the "history" of chosen positions".<sup>125</sup>

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<sup>123</sup> See "Economic Analysis of Law", above n 15, 17-21, 26-28.

<sup>124</sup> Mark G Kelman "Misunderstanding Social Life: A Critique of the Core Premises of "Law and Economics"" (1983) 33 L Legal Educ 274, 277.

<sup>125</sup> Kelman, above n 124, 277.

Two of the most insightful critiques of the rational actor model have come from Leff<sup>126</sup> and Ellickson<sup>127</sup>. In his article Leff emphasised that the assumption of rationality exaggerates actual human cognitive capabilities. While such a model was attractive because of its simplicity a richer model could perhaps be developed by incorporating insights from disciplines such as psychology, anthropology and sociology.<sup>128</sup> Further the assumption of utility maximisation was in essence unable to be disproved given utility is essentially unobservable and thus nearly impossible to measure. Ellickson in turn drew and built on the insights provided by Leff. Ellickson submits that Law and Economics “should increasingly look to psychology and sociology in order to enrich the explanatory power and normative punch of economic analysis”.<sup>129</sup> Law and Economics, in order to strengthen and improve the plausibility of its models, must seek to incorporate “more realism about both human frailties and the influence of culture”.<sup>130</sup> To Ellickson psychology and sociology are of central importance. Psychology can provide insights into innate human systems of perception and cognition, while sociology can help economists understand how social forces influence human behaviour.<sup>131</sup> For example psychology teaches us that cognitive limitations may impair people’s understanding of incentives, while some people are closed-minded, and having established a certain view of the world may wall out information that threatens the maintenance of those views.<sup>132</sup> Further insights include the fact that some people have greater will power than others, and the communicability of legal rules will affect their effectiveness.<sup>133</sup> While economists take tastes as given and stable, sociology can teach us about the influence of people upon one another, and the way social influences and internalisation can shape a person’s internal tastes and preferences and thus their demand for certain goods and services.<sup>134</sup> Ellickson ends his article with the comment that “The mark of a true

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<sup>126</sup> Arthur Leff “Economic Analysis of Law: Some Realism About Nominalism” (1974) 60 Va L Rev 451.

<sup>127</sup> Ellickson, above n 17.

<sup>128</sup> See Leff, above n 126, 470-474.

<sup>129</sup> Ellickson, above n 17, 23.

<sup>130</sup> Ellickson, above n 17, 25.

<sup>131</sup> Ellickson, above n 17, 35.

<sup>132</sup> Ellickson, above n 17, 40, 42; For the insights from psychology generally see Ellickson, above n 17, 35-43.

<sup>133</sup> Ellickson, above n 17, 43, 41.

<sup>134</sup> Ellickson, above n 17, 44-45.

economist is not fealty to the classical rational actor model, but rather openness to any techniques that would improve understanding of complex human behaviour”.<sup>135</sup>

The insights by Kelman, Leff and Ellickson are all pertinent, and it may be true that the incorporation of disciplines such as psychology and sociology would improve the predictive power of economic models. The impact of such criticisms can be seen in more recent Law and Economics scholarship, and Posner has commented that “[t]o some extent ... Ellickson is preaching to the converted”.<sup>136</sup> One example that comes to mind is Cooter and Ulen’s story of “Saturday Night Fever”.<sup>137</sup> The authors acknowledge that many crimes and torts occur under conditions of diminished rationality. Many crimes result from lapses in rationality, for example where young men temporarily lose control and act impulsively.<sup>138</sup> Cooter and Ulen term such behaviour “Saturday Night Fever”, and have sought to model such lapses by incorporating the concept of “prudence” into the economic model. Prudence, as defined by Cooter and Ulen, involves giving reasonable weight to the future consequence of our actions, while imprudence involves giving less than reasonable weight to future consequences. Thus when a teenage male is seeking to impress his girlfriend by squaring off with another suitor in a fit of jealousy, or showing off in front of his friends by keying someone’s car he may act imprudently by discounting the future consequences of his actions, and thus not acting rationally in the face of disincentives provided by probable punishment under criminal law. If individuals are prone to such lapses in rationality they will likely commit a disproportionately high number of crimes. Such lapses are more typical among certain groups such as youth (because of immaturity) and alcoholics (substance abuse causing greater mood variability). Because such groups discount potential punishment heavily in the course of lapses Cooter and Ulen suggest it may be more effective in terms of deterrence to invest in certain and immediate punishments rather than harsh punishments. Further social policies can reduce crime by reducing variability in moods, for example making alcohol and drugs less accessible. Thus by acknowledging that at times individuals are not rational the economic model can be more effective in gauging incentives and constructing strategies for the reduction of crime.

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<sup>135</sup> Ellickson, above n 17, 55.

<sup>136</sup> Ellickson, above n 17, 60.

<sup>137</sup> Cooter and Ulen, above n 6, 464-466.

However in my view it is important not to go too far in reforming the economic model. First, it is important to note that economics is concerned with explaining and predicting tendencies and aggregates rather than the behaviour of each individual person, and in a large sample deviations from rationality will be negligible.<sup>139</sup> Second, as Posner has said in response to Ellickson's article, "too many bells and whistles will stop the analytic engine in its tracks".<sup>140</sup> Resorting too easily to other disciplines involves the risk of overlooking promising developments in economic research and development, while a commitment to the economic model forces analysts, lawyers and judges to think hard before looking beyond the simple explanatory power of rationality.<sup>141</sup> Further "there is a danger of information overload if the economically-minded lawyer feels obliged to become a master of additional social sciences as well".<sup>142</sup> Posner, in response to Leff, justifiably stated that the role of models and theory is to simplify, and as such the simplicity of the economic model was not necessarily a ground for criticising it.<sup>143</sup> There is a necessary trade-off (as will be discussed below) in any form of modelling between the complexity and predictive robustness of a model, and the simplicity of a model. If a model becomes too complex it becomes inaccessible. Third, microeconomic models themselves demonstrate "human" values, traits and behaviour in any case. For example the tit-for-tat game in game theory, where economic actors repeatedly interact over repeated games, involves strategic behaviour, loyalty, integrity, cooperation, trust, reciprocity, punishment, and reputation considerations.

A further point should be made which is to some degree missed by the critics. The key analytical tools of the law include concepts such as "the reasonable man" and objective analysis. Such concepts, by which human conduct is assessed, hold defendants to higher levels of responsibility and conduct than what would be expected of the "average joe". The reasonable man is an imaginary person given life by lawyers and judges who always thinks before he acts, taking into account every reasonably

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<sup>138</sup> Cooter and Ulen, above n 6, 464.

<sup>139</sup> "Economic Analysis of Law", above n 15, 18.

<sup>140</sup> Richard A Posner "The Future of Law and Economics: A Comment on Ellickson" (1989) 65 *Chickent L Rev* 57, 62 ["Future of Law and Economics"].

<sup>141</sup> "Future of Law and Economics", above n 140, 62.

<sup>142</sup> "Future of Law and Economics", above n 140, 60.

<sup>143</sup> Richard A Posner "The Economic Approach to Law" (1975) 53 *Tex L Rev* 757, 773-775.

foreseeable outcome that could result from his actions, and always taking into account the possible impacts of his actions on his neighbours. The reasonable man will always take reasonable care, never being reckless or careless or suffering a lapse of concentration. In many ways the reasonable man is super-human. Thus it is not only economics that is based on assumptions and standards which in reality do not always hold true, the law also follows in this vein. This similarity is perhaps best illustrated by the famous case of *Carroll Towing* where the standard of reasonable care in negligence was assessed by reference to the rational degree of precaution that would prevail where the marginal cost of one unit of extra precaution exactly equaled the marginal benefit that would accrue from one extra unit of precaution.<sup>144</sup>

### ***B Empirical Evidence and Assumptions***

Economic models, in general, are based heavily on assumptions and maxims such as perfect information and the law of demand. However critics have been quick to suggest that in many cases such assumptions do not hold true, and are not supported by empirical evidence. The jurisprudence of some judge-economists, such as Posner, has been criticised on the basis that empirical assumptions are often not stated and assumptions are not supported empirically.<sup>145</sup> Such incomplete and unscientific analysis is unlikely to lead to robust and justifiable judicial decisions.

Sir Ivor Richardson has said in regard to tort law "... without adequate data and the consideration of a range of views there is a risk that an impressionistic economic analysis will add little to existing intuitive assessments of the public interest considerations"<sup>146</sup> and further "[o]ne of the major challenges facing the courts, the legal profession and the public sector generally is how to obtain and test economic and social data to ensure that existing rules and policy alternatives are assessed in an informed and systematic way".<sup>147</sup> Posner himself has also noted the importance of empirically testing hypotheses.<sup>148</sup> Without solid empirical evidence upon which to

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<sup>144</sup> *United States v Carroll Towing Co* (1947) 159 F 2d 169 (2nd Cir) Learned Hand J.

<sup>145</sup> See for example George M Cohen "Posnerian Jurisprudence and Economics Analysis of Law: The View from the Bench" (1985) 133 U Pa L Rev 1117, 1154-1158.

<sup>146</sup> "Inaugural Address", above n 4, 5; See also "Law and Economics", above n ??, paras 48-51.

<sup>147</sup> "Inaugural Address", above n 4, 6.

<sup>148</sup> "Future of Law and Economics", above n 140, 61-62.

base economic analysis, the economic approach to the law loses its value as a helpful analytical framework.

On the other hand there is truth in Posner's response to such criticisms that simply because some assumptions commonly made in economics studies are "false" (for example perfect competition, perfect knowledge), it does not falsify the studies that utilise them.<sup>149</sup> Studies which use unrealistic assumptions can still be successful in correctly predicting results, outcomes and behaviour. Such studies can still produce correct qualitative results, and "tolerably reliable" quantitative results.<sup>150</sup> In this regard, Posner submits that even if the assumptions that underlie economics do not reflect reality the economic model has fared well in terms of its predictive and explanatory power.<sup>151</sup> Further all models must be based on some form of assumption: such is the nature of modelling.

### *C Conservatism and Activism*

On one hand Law and Economics, particularly the Chicago strand, has been criticised as promoting a conservative right wing ideology.<sup>152</sup> On the other hand Law and Economics has also been criticised for providing a disguise for judicial activism. These two criticisms are addressed here.

Posner has responded to claims of conservatism by reasoning that Law and Economics can be used to support liberal as well as conservative viewpoints.<sup>153</sup> He points to the fact that Law and Economics supports "liberal" outcomes such as the right to counsel and the standard of proof in criminal cases. Further he states that "[p]erhaps the best evidence that economic analysis of law is ideologically neutral or balanced is the significant number of prominent practitioners of it who are decidedly liberal".<sup>154</sup> Posner goes on to cite names such as Guido Calabresi and Daniel

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<sup>149</sup> "Uses and Abuses", above n 74, 303; Although relaxing them in many cases will affect conclusions.

<sup>150</sup> "Uses and Abuses", above n 74, 303.

<sup>151</sup> "Economic Analysis of Law", above n 15, 17-18.

<sup>152</sup> See for example Cohen, above n 145 in regard to Posner; See also Eleanor M Fox "The Politics of Law and Economics in Judicial Decision Making: Antitrust as a Window" (1984) 61 NYU L Rev 554, 576 (in regard to Easterbrook), 588 (generally).

<sup>153</sup> "Economic Analysis of Law", above n 15, 27.

<sup>154</sup> "Economic Analysis of Law", above n 15, 27.

Rubinfeld. I would agree with Posner that in principle Law and Economics, as with economics in general, is a neutral discipline that can be used to support positions and views of both liberals and conservatives.

However critics suggest that it is not the discipline itself that is skewed but rather its application by those such as Posner. For example Cohen targets Posner and says “instead of applying the theory as a conservative advocating a new methodology for general judicial use, Posner has applied the theory primarily to support his conservative ideology”.<sup>155</sup> Fox in this regard has aptly stated that “[t]he tools of economics may be neutral but we who select and use them are not”.<sup>156</sup>

Thus the criticism of Law and Economics as inherently a conservative doctrine must fail, but the acceptance of Law and Economics as a neutral doctrine will depend on the way in which judges, lawyers and policy-makers choose to apply it.

Critics have also pointed to Law and Economics as a tool of “judicial activism”.<sup>157</sup> The focus of Law and Economics scholars is on the creation of rules that serve to create efficient incentives for society. Commentators have contended that by turning away from the dispute at hand to focus on incentive effects and efficiency judge-economists engage in judicial activism. Wald states: “Indeed, many define the sin of judicial activism as turning away from the dispute at hand to focus on broader questions of social policy. Yet what else are economists’ “rules” but economic and social policy?”.<sup>158</sup> In fact the involvement of the judiciary in economic policy and the determination of societal goals is arguably an intrusion upon the executive and legislative spheres of government. One could ask whether it is truly the judge’s role to take on a quasi-policy making role.<sup>159</sup> For example interpreting statutes with a view to promoting economic efficiency can frustrate Parliament’s intention. In this context Fox has commented on Easterbrook’s construction of the United States Antitrust laws, saying: “It is difficult to understand the Easterbrook formulation as anything other

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<sup>155</sup> Cohen, above n 145, 1151.

<sup>156</sup> Fox, above n 152, 558.

<sup>157</sup> While I am uncomfortable with using labels such as “activist”, given its ambiguous and subjective meaning, this is the terminology used by the commentators.

<sup>158</sup> Patricia M Wald “Limits on the Use of Economic Analysis in Judicial Decision-Making” (1987) 50 *Law & Contemp Prob* 225, 230.

<sup>159</sup> See further Wald, above n 158, 231.

than activism: an attempt to impose on society a personal vision of what kind of society we should be”.<sup>160</sup> Epstein has also weighed into the debate by arguing that much of the activism among American judges has sprung from “their own confidence on economic issues”.<sup>161</sup> He posits that it is activist for a Court, after the fact, to superimpose its own view of rationality as *it* understands it upon, for example, parties to a contract.<sup>162</sup>

Such allegations of activism can be overstated. It is true that if a judge were to let the goal of efficiency rule every decision such practice would look like judicial activism. However the utilisation of positive (as opposed to normative) Law and Economics to inform, but not to dominate, judicial decision-making could hardly be described as activist. The use of a discipline such as economics, in appropriate areas of the Law, can only make for better-informed and reasoned decisions. The more insights and disciplines that feed into the judicial decision-making process the more “well-rounded” the decision. In response to Epstein’s proposition that judge-economists superimpose their own views of rationality upon parties before the courts, one could point to examples such as the use of the reasonable man test, the imposition of strict liability, and the use of purely objective tests to solve legal problems as demonstrating that the law does, and must, impose such standards upon the conduct of members of society.

In any case one must accept the fact that in reality judges often engage in policy-style analysis. For example in choosing to impose a duty of care in negligence judges often consider public policy<sup>163</sup>, and in weighing up whether the interests of society should serve to limit individual rights under section 5 of the NZBORA the courts weigh up economic and social considerations.<sup>164</sup> A good recent example of

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<sup>160</sup> Fox, above n 152, 573; See also Wald, above n 158, 242 where the author comments on the Posner/Easterbrook mode of statutory interpretation, saying: “this seemingly “neutral” theory of statutory construction leads inextricably to more narrow construction of more statutes and to more private governance”.

<sup>161</sup> Richard A Epstein “Do Judges Need to Know Any Economics” [1996] NZLJ 235, 239 [“Do Judges Need to Know Any Economics”]

<sup>162</sup> “Do Judges Need to Know Any Economics”, above n 161, 238-239.

<sup>163</sup> See for example *Gartside v Sheffield, Young & Ellis*, above n 53, 49-52 Richardson J; *Lai v Chamberlains* (8 March 2005) CA17/03; CA15/03; For policy considerations in negligence cases see generally Todd, above n 44, para 4.3.

<sup>164</sup> See for example *Moonen v Film and Literature Board of Review* [2000] 2 NZLR 9, para 18 (CA) Tipping J for the Court.

such a policy-based decision is the New Zealand Court of Appeal's decision to create a tort of invasion of privacy in *Hoskings*.<sup>165</sup> Thus whatever one thinks of judges entering the public policy sphere, the reality is that they often do, and are often required to do so for the proper discharge of their role.

#### ***D Over simplicity, Over complexity and Opaqueness***

Some criticise the simplicity of Law and Economics analysis, while others criticise its complexity. To some degree the discipline is caught in a "Catch-22".

Commentators criticise Law and Economics as over simplistic. They contend that economic analysis tends "to reduce the various dimensions of a problem to a common denominator".<sup>166</sup> Tribe comments "[t]he inevitable result is not only that "soft" variables – such as the value of vindicating a fundamental right or preserving human dignity – tend to be ignored or understated, but also that entire problems are reduced to terms that misstate their structure and that ignore the nuances that give these problems their full character".<sup>167</sup> Bloustein has commented that Posner's theory is "simplistic, not simple, because it accomplishes its objective by avoiding, rather than confronting, complexity. He seduces by reduction, rather than conviction".<sup>168</sup> Such simplicity, it has been argued, leads to incomplete decision-making that fails to take into account all relevant factors.

On the other hand Law and Economics has been attacked on the basis that it is overly complex. Some like Epstein argue that simple rules should replace complex economic analysis, which is hard to apply in practice.<sup>169</sup> Wald suggests that the language of Law and Economics "can cloud, rather than clarify the legal issues" and that "phrasing the issues in the mathematical equations of quantitative economics

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<sup>165</sup> *Hoskings v Runtig* [2005] 1 NZLR 1 (CA).

<sup>166</sup> Laurence H Tribe "Constitutional Calculus: Equal Justice or Economic Efficiency" (1985) 98 Harv L Rev 592, 596.

<sup>167</sup> Tribe, above n 166, 596.

<sup>168</sup> Edward J Bloustein "Privacy is Dear at Any Price: A Response to Professor Posner's Economic Theory" (1978) 12 Ga L Rev 429, 429.

<sup>169</sup> See "Do Judges Need to Know Any Economics", above n 161; See also Richard A Epstein *Economics and the Judges: The Case for Simple Rules and Boring Courts* (New Zealand Business Roundtable, Wellington 1996).

usually does not help matters”.<sup>170</sup> Economic jargon and analysis can be used to make controversial outcomes seem obvious, and give false credibility to a generalised balancing of interests.<sup>171</sup> The use of terms such as “externality” or “monopoly” make the outcome seem preordained.<sup>172</sup> Most importantly the use of overly complex economic analysis and concepts can make judgments inaccessible and impossible for those not trained in economics to comprehend.

Thus on the one hand the use of terms with specialised meanings, maths and graphs can make judgments inaccessible, while on the other hand the use of overly simplistic rules to solve legal problems leads to issues not being assessed in their full light, incomplete reasoning, and a lack of analysis. Further, even if a model is simple the language in which it is conveyed may make it inaccessible.

Whether a judgment is overly complex or overly simplistic it will be opaque in that the true rationale and reasons behind the decision will not be obvious. Such opaque decision-making is undesirable as it can lead to arbitrariness and caprice. As such it is crucial to ensure that judicial decisions that draw on Law and Economics strike a balance, a middle ground, between complexity and simplicity.

Ellickson has stated that “[t]he trade-off between theoretical simplicity and predictive power is a difficult one”.<sup>173</sup> He further states that the “simplicity of the law and economics paradigm was one of its chief virtues; simplicity makes ideas more accessible, applications more obvious”.<sup>174</sup> Posner has also voiced his preference for simplicity.<sup>175</sup> The benefit of a model in the first instance is to explain complex phenomena through a simple and accessible construct. As the model gets more complex, it gains predictive power and greater reliability, however loses the essence of why it was created: “A theory that sought faithfully to reproduce the complexity of the empirical world in its assumptions would not be a theory – an explanation – but a description”.<sup>176</sup> Given such reasoning it is integral to maintain the inherent simplicity

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<sup>170</sup> Wald, above n 158, 236.

<sup>171</sup> Wald, above n 158, 236-237.

<sup>172</sup> Wald, above n 158, 236.

<sup>173</sup> Ellickson, above n 17, 25.

<sup>174</sup> Ellickson, above n 17, 24.

<sup>175</sup> “Uses and Abuses”, above n 74, 301.

<sup>176</sup> “Economic Analysis of Law”, above n 15, 17.

of the economic model. As a substitute for complexity factors of a less economic nature (for example the value of human rights) can perhaps be assessed outside the model, yet factored into the decision by the judge.

Overall it seems judges must use and explain a model that is just elaborate enough to be “complete” and provide a full enough analysis, while not being overly complex, and also be able to explain and convey the analysis in terms that are accessible to those not trained in economics.

### *E Subjectivity*

As stated above one of the oft-cited benefits of the economic analysis of law is that it provides a neutral objective framework within which to analyse legal issues. However some have come to question whether Law and Economics does actually provide a framework any less subjective than the typical legal framework of justice, fairness and equity.

Macey frames this criticism well when he says “economic theory cannot supply the value judgments necessary to implement its own insights. The legal system must do so, and it does”.<sup>177</sup> To illustrate his point Macey gives the example of the standard of proof in criminal cases.<sup>178</sup> Economics can tell us that one kind of error in criminal cases is letting a guilty person go free, while another type of error consists of convicting an innocent person. If one were to set a high standard of proof the result would be a reduction in the second type of error, but an increase in the first type. And if one were to set a low standard of proof the reverse would be true. While economics can help to frame and elucidate the problem it cannot however provide the vital value judgment as to which standard should be chosen, thus not in fact reducing the subjective element of decision-making.

Subjectivity also enters the fray in the quintessentially economic practice of cost-benefit analysis. For example what is a cost? And what is a benefit? Such

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<sup>177</sup> Jonathan R Macey “The Pervasive Influence of Economic Analysis on Legal Decisionmaking” (1994) 17 Harv J L & Pub Policy 107, 115.

<sup>178</sup> Macey, above n 177, 114.

judgments are not objective, but can often be as subjective as deciding what the “just” outcome of a case should be. Simply because a cost-benefit analysis looks methodical does not make it value-free. Further once factors are allocated a status as costs or benefits, the decision of how much weight to attribute to each factor will be essentially determinative of the final outcome. Because the answer to a balancing exercise such as cost-benefit analysis cannot always be given by the application of economic principles, but will require a final value judgment, it is questionable whether economic analysis can provide a more robust, and less subjective method of deciding cases. As Fox has said judgments derived from neither economics or law enter the fray at the various stages of economic decision-making: the first stage of formulating the economic question to be answered, the second stage of choosing the assumptions of the model to be applied, and at the final stage of tallying the costs and benefits.<sup>179</sup>

While insightful, the problem with the above criticisms is that they assume that Law and Economics purports to remove subjectivity and value-judgments from legal decision-making altogether. However no discipline or model can remove subjectivity altogether. It may be obvious to most but decision-making must involve some degree of subjective judgment. Further it would be dangerous if decision-making were done on a formulaic basis. Law and Economics does not and should not remove all subjectivity from decision-making. However what Law and Economics can do is provide a framework within which to analyse legal questions. The framework is neutral and objective, and encourages a systematic, consistent and methodical approach to legal questions. As such the use of the economic framework and economic decisional criteria in answering legal questions arguably makes for more principled decision-making than simply asking “what is just?” or “what is fair?”.

## ***VII THE “PROPER” ROLE OF LAW AND ECONOMICS***

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<sup>179</sup> Fox, above n 152, 576-585.

As established above the use of economic principles can greatly benefit legal analysis. However Law and Economics does have its limits. This section discusses the proper role of economic analysis in the law, with a view to discerning how and when the discipline is most appropriately applied. It uses two dimensions of economic approaches. In the first, the term “microeconomic model” is used to represent economic models commonly used in arguments before the Court. They are often relatively static in nature, having no specific time or evolutionary dimension. In the second, the forces of dynamic change and their interaction with institutions are recognised explicitly. This second dimension is more concerned with socially desirable processes than it is with particular outcomes. It is considered in Section E.

Sections A to D analyse the use of microeconomics in judicial decision-making, but the sections have implications for legal decision-making generally (for example in government and legislative policy formation). Topics discussed include the economic sophistication of judges (section A), the dangers of having efficiency as the sole aim of the law (section B), and the imprudence of overstretching the microeconomic model by applying it to areas of the law that are not appropriately analysed through the lens of microeconomic analysis (section C). Section D ties the analysis together, reaching a conclusion as to the proper role of microeconomic analysis in judicial decision-making.

As mentioned, Section E addresses the role of economic models other than the microeconomic model, which has traditionally been the basis of the Law and Economics literature. The section specifically considers models based on institutional economics which operate in the middle to long-run, and which can provide insights into the evolution of legal institutions and legal principles. The section encourages Law and Economics scholars to widen their application of economics to the law beyond the traditional, normally static, microeconomic model, arguing that other more recent and innovative economic models can add much to one’s understanding of the legal system.

### ***A Economic Sophistication***

The first point to be made is that the value of Law and Economics in judicial decision-making will depend on the “economic sophistication” of those applying it. Judges untrained in and unfamiliar with economics, who attempt to apply such analysis are “of questionable use to both the litigants and the ultimate social good”.<sup>180</sup> Judges when applying economic analysis must understand the underlying assumptions and fundamental principles of economics, how to apply those assumptions and principles to the facts before them, and the limits of such analysis.<sup>181</sup> Just as well intentioned but misconceived government intervention can lead to losses in efficiency rather than gains, so too can the economically unsophisticated judge run awry when attempting to resolve a case via the economic analysis of the law. Thus a precondition to the effective utilisation of Law and Economics in judicial decision-making is the training of judges in the subject of economics. In this regard perhaps New Zealand could follow the United States’ lead and put in place permanent specialist courses in economics for members of the judiciary.

### ***B The Danger of a Single Focus***

Some Law and Economics scholars have (at times) claimed that the goal of the common law should be, and is, the pursuit of efficiency.<sup>182</sup> While the pursuit of efficiency is important as it allows society to get the most out of its scarce resources, such a narrow focus is dangerous as other weighty considerations may be ignored.

While the central goal of the microeconomic model is efficiency, the same cannot be said for the legal system. While subjective, most lawyers would agree that the aim of any legal system is justice. Because an efficient outcome is not always a just one, it would be inappropriate to have efficiency as the sole or principal decision-making criterion in judicial decision-making. The microeconomic model cannot properly measure and take into account variables such as fairness or equity. Yet such values are considered fundamental to justice and the legal system. The microeconomic model has never claimed, nor purported to be able to measure and take into account such intangible values. The fact is that such values exist as factors

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<sup>180</sup> Wald, above n 158, 230.

<sup>181</sup> See Wald, above n 158, 228.

outside the model, as do central constitutional principles such as the rule of law. As such the microeconomic model cannot be the be all and end all of judicial decision-making.

Because other considerations exist exogenous to the microeconomic model the “art” of judging cannot be reduced to a formula whereby the relevant factors and considerations are entered as inputs and an economic formula determines what the result should be. Economics can only be one of a number of factors that enter the decision-making process. For example Latin, in a survey of (then) United States Federal Court of Appeal Judge Breyer’s decisions, pinpointed several decisional criteria that factor into judicial decision-making.<sup>183</sup> These factors included global efficiency effects and micro efficiency effects, but also the allocation of institutional responsibilities, justiciability constraints, unquantifiable and incommensurable interests such as human rights, fairness and even-handed justice. Latin’s contention was that the decision of what weight to give each of those factors, and the consequent judicial balancing of those factors did not involve economic decisions but rather legal and ethical judgments. Latin further said that “[w]hile economic analysis of microefficiency effects may be relevant to the necessary judicial consideration, it can rarely if ever be decisive by itself”.<sup>184</sup>

While microeconomics can help to analyse and solve legal issues it can never supplant justice as the central goal of the legal system, nor can it be allowed to fetter the exercise of judicial discretion so as to undermine other central principles of the legal system such as fairness and equity. However, in saying this, it is important to bear in mind that where one favours legal rules based on considerations other than efficiency, one risks choosing legal rules that would make every person in society worse off, in that rules will not necessarily maximise society’s wealth.<sup>185</sup>

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<sup>182</sup> See for example Richard A Posner “Wealth Maximization and Judicial Decision-making” (1984) 4 *Int’l Rev Law & Econ* 131.

<sup>183</sup> See Howard Latin “Legal and Economic Considerations in the Decisions of Judge Breyer” (1987) 50 *Law & Contemp Prob* 57.

<sup>184</sup> Latin, above n 183, 71.

<sup>185</sup> See Louis Kaplow and Steven Shavell “The Conflict Between Notions of Fairness and the Pareto Principle” Harvard Law School Discussion Paper No 252 3/99.

### *C Overstretching Law and Economics*

Microeconomic analysis “fits” particularly well with some areas of the law such as anti-trust, contract and commercial law where the subject-matter of the law is market-based activity. However the application of Law and Economics becomes more contentious when it is applied to activities and subject-matter that occur outside of the market. For example it may be inappropriate to apply Law and Economics to family law or refugee law where there are values at stake that are not given weight or accounted for in the microeconomic model. The bond between a mother and child, or the possibility that a refugee might be tormented by the authorities of their home state upon deportation cannot be measured in empirical terms. When Law and Economics scholars attempt to “stretch” the economic model to encompass such areas of the law the movement loses credibility, because the results of such application can often be inconsistent with other weighty values in the legal system such as justice and fairness. An example is Posner’s argument that baby sales should be allowed to solve the “baby shortage”. Posner says “[t]he baby shortage would be considered an intolerable example of market failure if the commodity were telephones rather than babies”.<sup>186</sup> Such comparisons between market commodities and human beings would be considered objectionable by most if not all people.

One area in particular where microeconomics will typically have a more limited role is in constitutional and human rights law.<sup>187</sup> The operation of this area of the law is so fundamental to the proper functioning of the rule of law and a free, fair and open democratic society that efficiency considerations should be applied with caution. For example in the case of *Martin v Tauranga District Court* the Court of Appeal held that the Government pay for a new court house to be built to ensure access to justice and a speedy trial under the NZBORA.<sup>188</sup> The Court, in that case, had no express recourse to the economic implications for the government, and did not

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<sup>186</sup> “Economic Analysis of Law”, above n 15, 156.

<sup>187</sup> Justice Kirby of the High Court of Australia has discussed the interaction between the human rights and Law and Economics movements and the difficulties judiciaries will face in reconciling the two: Michael Kirby “Law and Economics: Is There Hope?” (Melbourne, 4 July 1997); Available at High Court of Australia <[http://www.hcourt.gov.au/speeches/kirbyj/kirbyj\\_lawecon.htm](http://www.hcourt.gov.au/speeches/kirbyj/kirbyj_lawecon.htm)> (last accessed 25 June 2005); See also Sir Anthony Mason “Law and Economics” (1991) 17 Monash U LR 167, 175.

<sup>188</sup> *Martin v Tauranga District Court* [1995] 2 NZLR 419 (CA).

engage in an explicit cost-benefit analysis.<sup>189</sup> In *Baigent's Case* the Court of Appeal established a new civil remedy which provided that the state may be liable to pay compensation to an individual whose rights guaranteed under the NZBORA had been infringed.<sup>190</sup> The decision had recourse to considerations such as New Zealand's responsibilities under international law, and public law principles that where there is a right there is a remedy. However the Court did not have recourse to the economic burden that would be imposed on the state, and the costs and benefits of creating such a new cause of action. Commentators support such an approach: for example Cooter comments that "the judiciary is instrumental in protecting and strengthening our basic liberties" and where the judiciary must decide cases affecting basic liberties, liberty should not be sacrificed for wealth.<sup>191</sup>

I agree in principle with commentators such as Cooter that microeconomic principles could not trump the fundamental values of the legal system. As such, judges should use microeconomic analysis with caution when cases concern areas such as constitutional and human rights law. However it must be said that to argue for caution is not to entirely discount the usefulness of microeconomics in regard to such decisions: to discount economic analysis without consideration would be folly. For example the potential usefulness of applying economics in the area of human rights was demonstrated by Hammond J's decision in *Udompun* discussed above, and his analogy between human rights and merit goods.<sup>192</sup> Further the Court of Appeal in *Moonen* stated that section 5 of the NZBORA, which deals with limiting rights, specifically required the weighing of economic considerations.<sup>193</sup> Also, the rules of the constitution, as with all rules, structure and influence social interaction, and as such the economics of incentives can inform the interpretation and application of constitutional rules.<sup>194</sup> Thus, while microeconomics may be expected to play a less prominent role in some areas of the law such as human rights and constitutional law, it should not be discounted without a consideration of its usefulness and insights.

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<sup>189</sup> The Court may not have engaged in an explicit cost-benefit analysis but it must have had one in mind. Otherwise the decision would imply a blanket rule that there is no price too high for the fulfillment of rights.

<sup>190</sup> *Simpson v A-G [Baigent's Case]* [1994] 3 NZLR 667 (CA).

<sup>191</sup> Robert D Cooter "Liberty, Efficiency, and Law" (1987) 50 *Law & Contemp Prob* 141, 161-162.

<sup>192</sup> See Part V B 3 Liability: Bill of Rights and torts damages.

<sup>193</sup> *Moonen v Film and Literature Board of Review*, above n 164, para 18 Tipping J for the Court.

<sup>194</sup> See Newman, above n 64, 401-409; In regards to the economics of the constitution see also Robert Cooter *The Strategic Constitution* (Princeton University Press, Princeton, 2000).

#### ***D Conclusion on the Role of Microeconomics in Decision-making***

The conclusions that can be taken from the above discussion are threefold. First, economic tools and analysis are best left to those with formal training in economics. Such individuals will have a fuller understanding of economic principles and how to apply such principles. The use of powerful economics tools by those who do not fully understand them will likely lead to more harm than good. Second, microeconomics and efficiency cannot be the sole decision-making criteria in judicial decision-making, but are more appropriately used as one of a number of considerations. As Posner himself has said “there is more to justice than economics”.<sup>195</sup> Third, how much weight will be given to microeconomic considerations will depend on the subject-matter of the particular legal dispute. On the applicability of Law and Economics to judicial decision-making in different areas of the law Fox has said “Antitrust stands at one end of the spectrum; it is among the legal disciplines that are most nearly efficiency-based. Constitutional law stands at the other end of the spectrum; it is the genre of the law that is most clearly rights-, freedom-, and process-based”. Thus the appropriateness of applying, and the degree of reliance placed on microeconomic analysis will turn on whether the subject matter of the dispute is market-based activity (such as contract and commercial law), or activities that operate outside the microeconomic model (such as family, human rights and constitutional law). It is also important to note that while less reliance may be placed on microeconomic analysis in certain areas of the law, the microeconomic elements of legal decisions should at the least be taken into consideration, no matter the area of law at issue.

#### ***E Short Run vs Long Run and the Economics of Institutions***

Most of the literature on Law and Economics (including this paper) has focused on the interaction between the *microeconomic model* and the law in the short-run. Many of the critiques of Law and Economics have attacked the place of the microeconomic model, and its goal of efficiency, in the law. However, both

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<sup>195</sup> “Economic Analysis of Law”, above n 15, 28.

protagonists of Law and Economics, and critics often fail to consider economic models other than the short-run microeconomic model: for example the recently developed dynamic economic models that operate into the middle-run and long-run, which incorporate the economics of institutions and the dynamics of economic and social forces and conditions can tell us much about why the institutional legal framework and certain legal principles have developed, and how they have developed. To limit the role of economics in the law to the short-run microeconomic model, and to ignore its more recent and richer contribution to understanding the dynamics of change and evolution of institutions over time, is to unjustifiably limit the contribution that economics can make to the study of the law.

Above I said that microeconomic considerations and efficiency cannot trump more fundamental legal principles. I also said that certain values operate outside the microeconomic model, and are not appropriately analysed via such a model. However simply because the microeconomic model (which is characteristically associated with Law and Economics) is of limited use in some areas, does not mean that other models, such as the longer-run institutional models, cannot be instructive, informative, and have implications for decisions. Those models can help to explain how economic and other forces and conditions have moulded legal institutions and legal principles, and why and how such institutions and principles have evolved over time. One indicator of the effect of consideration of dynamic economic repeated transaction models, for example, is that they can rationalise a balance between cooperation and competition that may manifest itself in informal transaction rules that look like principles of fairness. Dynamic repetition also suggests forces of institutional design.

Take the further example of constitutional law. The microeconomic theory and efficiency criterion have been critiqued by Professor Tribe in his article “Constitutional Calculus: Equal Justice or Economic Efficiency”.<sup>196</sup> Tribe in his conclusion strongly states his position: “we cannot avoid conceding that constitutional decisions, whether bearing on the distribution of power or on other constitutive dimensions of our polity, must be made as fundamental choices of principle, not as

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<sup>196</sup> Tribe, above n 166.

instrumental calculations of social utility”.<sup>197</sup> Tribe’s comments have an instinctive appeal because they talk of “principle”, and denounce “instrumental calculations”. But what is this “principle” that Tribe attributes so much weight to? And why is it that “social utility” could not enter into decisions regarding the constitution? Surely the “fundamental choices of principle” Tribe refers to are shaped by a number of forces such as social and political conditions and considerations, and also economic forces. The constitution, and the law, do not operate in a vacuum: to a degree they are a reflection of the wider context in which they operate, which will inevitably include markets, economic forces and economic conditions.<sup>198</sup> Thus while the applicability of microeconomics to the constitution may be limited, long-run dynamic institutional models that take into account economic and social forces can be highly relevant.<sup>199</sup>

A prime example of institutional evolution is the development processes that enhanced trade. A formal institutional process to enhance trade can be traced at least as far back as the 11<sup>th</sup> century when the Maghribi trader coalition evolved to enable more efficient trade at long distances, although there was no court or judiciary to enforce the coalition.<sup>200</sup> The coalition arose from social linkages and associated norms to a system of reward and punishment of principals and agents that enabled trade at distances that had not been possible before. Trading institutions, including the provision of arbitration and courts for dispute settlement, continued to evolve over time in response to various factors that inhibited trade among and between very different peoples. The judicial processes which evolved were designed to facilitate the surety of trading arrangements and the detail of the judicial processes flowed on from that.<sup>201</sup> The very existence and utility of the trading arrangements came to depend upon an objective judicial process, in other words, an “institutional arrangement” that produced decisions that were guaranteed to be fair in process. As such, the

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<sup>197</sup> Tribe, above n 166, 621.

<sup>198</sup> See for example Roger Lagunoff “A Theory of Constitutional Standards and Civil Liberty” (2001) 68 *Review of Economic Studies* 109; Torsten Persson and Guido Tabellini “Constitutions and Economic Policy” (2004) 18(1) *Journal of Economic Perspectives* 75.

<sup>199</sup> Other areas of economics such as industrial organisation can also be relevant – such economic analysis can help in the allocation of responsibilities between the three branches of government, and in deciding upon the design of the constitution: See for example “Economic Analysis of Law”, above n 15, ch 24.

<sup>200</sup> See Avner Greif “Contract Enforceability and Economic Institutions in Early Trade: the Maghribi Traders’ Coalition” (1993) 83(3) *American Economic Review* 525.

development of judicial processes and judicial principles governing trade were a response to a dynamic and evolving economic and social climate: legal institutions and principles arose in response to social and economic forces.

The evolution of the legal system and the norms that inform judicial decision-making are a topic of active enquiry and research by economists. Some have taken a social institutional approach to explain the interaction between social norms and the law.<sup>202</sup> Others have sought to explain how social norms create institutions for achieving commercial and social cooperation in the presence of self interest.<sup>203</sup> Williamson has directly considered the importance and role of economics in the design of institutions<sup>204</sup>, while the design of legislative institutions has been considered by Krehbiel.<sup>205</sup>

Thus while the microeconomic model and efficiency as a decision-making criterion have their limitations in terms of their application in short run judicial-decision making, other middle-run to long-run models of economic change, which also integrate other social sciences can inform one's understanding of legal institutions and legal principles, and how those institutions and principles change and are moulded over time, depending on the economic and social context within which they operate. Those interested in the economic analysis of the law should not tie themselves to the microeconomic model simply because it is the most familiar and well-established economic model in the Law and Economics strand of scholarship, but must also be open to the other many and varied branches of economic analysis which can contribute to one's understanding of the legal system.

## **VIII CONCLUSION**

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<sup>201</sup> See the example of Medieval champagne fairs: Barry Weingast, Paul R Milgrom and Douglass C North "The Role of Institutions in the Revival of Trade: The Medieval Law Merchant, Private Judges, and the Champagne Fairs" (1990) 2 Economics and Politics 1.

<sup>202</sup> See Amir N Licht "Social Norms and the Law: A Social Institutional Approach" (March 2005) available at <<http://ssrn.com/abstract=710621>>.

<sup>203</sup> See for example Douglass C North "Institutions" (1991) 5(1) Journal of Economic Perspectives 97.

<sup>204</sup> OE Williamson "The New Institutional Economics" (2000) 38 Journal of Economic Literature 595.

<sup>205</sup> Keith Krehbiel "Legislative Organisation" (2004) 18(1) Journal of Economic Perspectives 113.

While Law and Economics has had a pervasive influence in other jurisdictions, in particular the United States, the movement is still in its infancy in New Zealand. The growth of LEANZ and the interest of some New Zealand judges in Law and Economics are positive signs; however New Zealand has so far failed to reap the full benefits of incorporating efficiency as a guiding principle in the legal system. Perhaps a good starting point to remedy this problem is the incorporation of Law and Economics as a permanent fixture in the curricula of New Zealand Law Schools, and appointment of Law and Economics scholars to the staff lists of the Law Schools. It is through educating the lawyers, legal policy-makers, academic lawyers and judges of the future that New Zealand can take positive steps towards reaping the benefits of the economic analysis of law.

The benefits of factoring the economic analysis of law into legal decision-making are several fold. First, such analysis encourages the creation of legal rules that facilitate the maximisation of society's welfare. Second, economics can teach law-makers the behavioural and incentive effects of different rules, making for more informed law-making. Third, Law and Economics provides a neutral normative framework within which to analyse legal questions, thus promoting more principled, methodical and consistent decision-making. Fourth, economics draws on empirical evidence. Empirical facts and statistics can make for better decision-making criteria than intuition and informed guesses. Fifth, given economic principles such as competition are embedded in the law, lawyers and judges must understand such principles so as to properly discharge their functions. Sixth, in general lawyers and judges should be concerned with other disciplines so as to enrich the law.

As with any discipline Law and Economics does have its critics and its limitations, but recognition of such critiques and limitations can only serve to strengthen and promote the discipline. Economics must be applied only by those who have had training in, and understand economics and its limitations. Most importantly microeconomics and efficiency cannot form the sole decision-making criteria in legal decision-making. As Cohen has said the proper role of Law and Economics is "to supplement, rather than supplant, traditional legal analysis".<sup>206</sup> Also, the

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<sup>206</sup> Cohen, above n 145, 1165.

appropriateness of the application of microeconomic principles to law will turn on the area of law at issue.

Lastly, Law and Economics scholars must not slavishly be tied to the traditional microeconomic model. An awareness and understanding of other economic models such as long-run dynamic institutional models can contribute much to one's understanding of the evolution and development of legal institutions and legal principles.

Overall, a proper and principled application of Law and Economics, that recognises the limitations of microeconomic analysis, and which takes into account other valuable economic models, can serve to reap the benefits economic analysis can provide.

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