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Law and Economics

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Law and economics begins with the premise that, under the assumptions of the so-called Welfare Theorems,[1] markets lead to an efficient allocation of resources. Since these are theorems – the conclusions follow logically and inescapably from the assumptions – they can only be questioned by reference to those assumptions. An intervention – such as a prohibition, tax, subsidy, or regulation – must be justified by pointing to one of the assumptions of the Welfare Theorems being violated, such as: the presence of asymmetric information, the existence of transaction costs, or non-price-taking behaviour. In practice, these violations are common, but beginning with the premise that markets are efficient disciplines arguments for intervention by requiring the analyst to make a compelling case, rather than intervention being the default.

Extract 1: Ronald Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1 (references omitted)

> pp 8-10
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> The harmful effects of the activities of a business can assume a wide variety of forms. An early English case concerned a building which, by obstructing currents of air, hindered the operation of a windmill. A recent case in Florida concerned a building which cast a shadow on the cabana, swimming pool and sunbathing areas of a neighbouring hotel. The problem of straying cattle and the

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1 Kenneth J Arrow, 'An Extension of the Basic Theorems of Classical Welfare Economics' in *Proceedings of the Second Berkeley Symposium on Mathematical Statistics and Probability* (University of California Press, 1951) 507-532.

damaging of crops which was the subject of detailed examination in the two preceding sections, although it may have appeared to be rather a special case, is in fact but one example of a problem which arises in many different guises. To clarify the nature of my argument and to demonstrate its general applicability, I propose to illustrate it anew by reference to four actual cases.

Let us first reconsider the case of *Sturges v Bridgman* which I used as an illustration of the general problem in my article on 'The Federal Communications Commission'. In this case, a confectioner (in Wigmore Street) used two mortars and pestles in connection with his business (one had been in operation in the same position for more than 60 years and the other for more than 26 years). A doctor then came to occupy neighbouring premises (in Wimpole Street). The confectioner's machinery caused the doctor no harm until, eight years after he had first occupied the premises, he built a consulting room at the end of his garden right against the confectioner's kitchen. It was then found that the noise and vibration caused by the confectioner's machinery made it difficult for the doctor to use his new consulting room. 'In particular … the noise prevented him from examining his patients by auscultations[2] for diseases of the chest. He also found it impossible to engage with effect in any occupation which required thought and attention'. The doctor therefore brought a legal action to force the confectioner to stop using his machinery. The courts had little difficulty in granting the doctor the injunction he sought. 'Individual cases of hardship may occur in the strict carrying out of the principle upon which we found our judgment, but the negation of the principle would lead even more to individual hardship, and would at the same time produce a prejudicial effect upon the development of land for residential purposes'.

The court's decision established that the doctor had the right to prevent the confectioner from using his machinery. But, of course, it would have been possible to modify the arrangements envisaged in the legal ruling by means of a bargain between the parties. The doctor would have been willing to waive his right and allow the machinery to continue in operation if the confectioner would have paid him a sum of money which was greater than the loss of income which he would suffer from having to move to a more costly or less convenient location or from having to curtail his activities at this location or, as was suggested as a possibility, from having to build a separate wall which would deaden the noise and vibration. The confectioner would

2 Auscultation is the act of listening by ear or stethoscope in order to judge by sound the condition of the body.

have been willing to do this if the amount he would have to pay the doctor was less than the fall in income he would suffer if he had to change his mode of operation at this location, abandon his operation or move his confectionery business to some other location. The solution of the problem depends essentially on whether the continued use of the machinery adds more to the confectioner's income than it subtracts from the doctor's.[3] But now consider the situation if the confectioner had won the case. The confectioner would then have had the right to continue operating his noise and vibration-generating machinery without having to pay anything to the doctor. The boot would have been on the other foot: the doctor would have had to pay the confectioner to induce him to stop using the machinery. If the doctor's income would have fallen more through continuance of the use of this machinery than it added to the income of the confectioner, there would clearly be room for a bargain whereby the doctor paid the confectioner to stop using the machinery. That is to say, the circumstances in which it would not pay the confectioner to continue to use the machinery and to compensate the doctor for the losses that this would bring (if the doctor had the right to prevent the confectioner's using his machinery) would be those in which it would be in the interest of the doctor to make a payment to the confectioner which would induce him to discontinue the use of the machinery (if the confectioner had the right to operate the machinery). The basic conditions are exactly the same in this case as they were in the example of the cattle which destroyed crops. With costless market transactions, the decision of the courts concerning liability for damage would be without effect on the allocation of resources. It was of course the view of the judges that they were affecting the working of the economic system – and in a desirable direction. Any other decision would have had 'a prejudicial effect upon the development of land for residential purposes, an argument which was elaborated by examining the example of a forge operating on a barren moor, which was later developed for residual purposes. The judges' view that they were settling how the land was to be used would be true only in the case in which the costs of carrying out the necessary market transactions exceeded the gain which might be achieved by any rearrangement of rights. And it would be desirable to preserve the areas (Wimpole Street or the moor) for residential or professional use (by giving non-industrial users the right to stop the noise, vibration, smoke, etc., by injunction) only if the value of the additional residential facilities obtained was greater

3 Note that what is taken into account is the change in income after allowing for alterations in methods of production, location, character of product, etc.

than the value of cakes or iron lost. But of this the judges seem to have been unaware. …

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VI. The Cost of Market Transactions Taken into Account

The argument has proceeded up to this point on the assumption … that there were no costs involved in carrying out market transactions. This is, of course, a very unrealistic assumption. In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost.

In earlier sections, when dealing with the problem of the rearrangement of legal rights through the market, it was argued that such a rearrangement would be made through the market whenever this would lead to an increase in the value of production. But this assumed costless market transactions. Once the costs of carrying out market transactions are taken into account it is clear that such a rearrangement of rights will only be undertaken when the increase in the value of production consequent upon the rearrangement is greater than the costs which would be involved in bringing it about. When it is less, the granting of an injunction (or the knowledge that it would be granted) or the liability to pay damages may result in an activity being discontinued (or may prevent its being started) which would be undertaken if market transactions were costless. In these conditions the initial delimitation of legal rights does have an effect on the efficiency with which the economic system operates. One arrangement of rights may bring about a greater value of production than any other. But unless this is the arrangement of rights established by the legal system, the costs of reaching the same result by altering and combining rights through the market may be so great that this optimal arrangement of rights, and the greater value of production which it would bring, may never be achieved. The part played by economic considerations in the process of delimiting legal rights will be discussed in the next section. In this section, I will take the initial delimitation of rights and the costs of carrying out market transactions as given.

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… The discussion of the problem of harmful effects in this section (when the costs of market transactions are taken into account) is extremely inadequate. But at least it has made clear that the problem is one of choosing the appropriate social arrangement for dealing with the harmful effects. All solutions have costs and there is no reason to suppose that government regulation is called for simply because the problem is not well handled by the market or the firm. Satisfactory views on policy can only come from a patient study of how, in practice, the market, firms and governments handle the problem of harmful effects. Economists need to study the work of the broker in bringing parties together, the effectiveness of restrictive covenants, the problems of the large-scale real-estate development company, the operation of Government zoning and other regulating activities. It is my belief that economists, and policy-makers generally, have tended to over-estimate the advantages which come from governmental regulation. But this belief, even if justified, does not do more than suggest that government regulation should be curtailed. It does not tell us where the boundary line should be drawn. This, it seems to me, has to come from a detailed investigation of the actual results of handling the problem in different ways. But it would be unfortunate if this investigation were undertaken with the aid of a faulty economic analysis. The aim of this article is to indicate what the economic approach to the problem should be.

Extract 2: Guido Calabresi and A Douglas Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 *Harvard Law Review* 1089

pp 1108-1109

Of course, the problems with liability rules are equally real. We cannot be at all sure that landowner Taney is lying or holding out when he says his land is worth $12,000 to him. The fact that several neighbors sold identical tracts for $10,000 does not help us very much; Taney may be sentimentally attached to his land. As a result, eminent domain may grossly undervalue what Taney would actually sell for, even if it sought to give him his true valuation of his tract. In practice, it is so hard to determine Taney's true valuation that eminent domain simply gives him what the land is worth 'objectively', in the full knowledge that this may result in over or

under compensation. The same is true on the buyer side. 'Benefits' taxes rarely attempt, let alone succeed, in gauging the individual citizen's relative desire for the alleged benefit. They are justified because, even if they do not accurately measure each individual's desire for the benefit, the market alternative seems worse. For example, fifty different households may place different values on a new sidewalk that is to abut all the properties. Nevertheless, because it is too difficult, even if possible, to gauge each household's valuation, we usually tax each household an equal amount.

The example of eminent domain is simply one of numerous instances in which society uses liability rules. Accidents is another. If we were to give victims a property entitlement not to be accidentally injured we would have to require all who engage in activities that may injure individuals to negotiate with them before an accident, and to buy the right to knock off an arm or a leg.[4] Such pre-accident negotiations would be extremely expensive, often prohibitively so'. To require them would thus preclude many activities that might, in fact, be worth having. And, after an accident, the loser of the arm or leg can always very plausibly deny that he would have sold it at the price the buyer would have offered. Indeed, where negotiations after an accident do occur – for instance pretrial settlements it is largely because the alternative is the collective valuation of the damages.

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… Wherever transactions between Taney and Marshall are easy, and wherever economic efficiency is our goal, we could employ entitlements protected by property rules even though we would not be sure that the entitlement chosen was the right one. Transactions as described above would cure the error. While the entitlement might have important distributional effects, it would

4 Even if it were possible, it should be clear that the good which would be sold would not be the same as the good actually taken. If Taney waives for $1000 the right to recover for the loss of a leg, should he ever lose it, he is negotiating for a joint product which can be described as his 'desire or aversion to gamble' and 'his desire to have a leg'. The product actually taken, however, is the leg. That the two goods are different can be seen from the fact that a man who demands $1000 for a 1 in a 1000 chance of losing a leg may well demand more than $100,000 for a 1 in 10 chance of losing it, and more than $1,000,000 for the sale of his leg to someone who needs it for a transplant. … This does not mean that the result of such transactions, if feasible, would necessarily be worse than the result of collective valuations. It simply means that the situation, even if feasible, is different from the one in which Taney sells his house for a given price.

not substantially undercut economic efficiency. The moment we assume, however, that transactions are not cheap, the situation changes dramatically … Under these circumstances – and they are normal ones in the pollution area – we are likely to turn to liability rules whenever we are uncertain whether the polluter or the pollutees can most cheaply avoid the cost of pollution.

HOLDEN J:

[1] I have had the opportunity to read the judgment of Crennan, Kiefel and Bell JJ, and I concur in their Honours' decision to dismiss the appeal of Mr Monis and Ms Droudis. I write separately to outline my somewhat different reasons for reaching this conclusion.

[2] I begin by observing that under s 51(v) of the Constitution the Commonwealth Parliament has authority to regulate 'postal, telegraphic, telephonic, and other like services'. It is pursuant to this legislative power that the Commonwealth has enacted s 471.12 of the *Criminal Code*.

[3] In determining the validity of s 471.12 of the *Criminal Code*, a threshold question to address is whether the provision effectively burdens communication about government and political matters.[5] However offensive one may find the letters written by Monis and Droudis, they concern a policy pursued by the Commonwealth. They demonstrate the propensity of s 471.12 to burden communication about political matters, and hence one must answer this question in the affirmative.

[4] This brings us to the second limb of the so-called '*Lange* test'.[6] I will focus on two questions concerning the prohibition of certain kinds of offensive communications: (i) does it serve a legitimate government purpose, and (ii) is it narrowly tailored to achieving that purpose. On each of these questions economic reasoning offers a useful lens for understanding the issues.

[5] I will first address the question of whether a legitimate government purpose is served.

5 *Lange v Australian Broadcasting Corporation* (1997) 189 CLR 520.
6 Ibid, *Coleman v Power* (2004) 220 CLR 1.

[6] This is relatively easy to answer. Where a party or parties engage in conduct that imposes a cost or benefit on other parties who did not engage in the conduct, an externality is said to have been created. If the party or parties not engaging in the conduct receives a benefit the externality is said to be positive. Conversely, the externality is said to be negative if a cost is imposed. In this case, the speech in which Monis and Droudis engaged imposed a negative externality on the families of the servicemen who received the letter.

[7] The presence of an externality is not, *prima facie*, a rationale for government intervention. If I bid against you in an auction for a residential property I impose a negative externality on you: either by causing you to pay more to win the auction than you otherwise would have, or by outbidding you and causing you to not end up owning the property. This bidding, however, occurs in a market and the market's price mechanism (in this example, the rules of the auction) appropriately balance the harm I cause to you and other bidders with the benefit I generate for myself and the seller of the property.

[8] Even in the absence of a market, provided there are no transaction costs, then the parties should reach an efficient agreement themselves, without government action of any kind.[7] In such an instance the prohibition in question in this case would not serve a legitimate government purpose because bargaining between the parties would lead to an efficient amount of offensive speech – balancing the harm to the audience and the benefit to the speaker. If, however, there are sufficiently large transaction costs, an efficient agreement will not be reached because the benefits from shifting from whatever the initial allocation of rights is to the efficient allocation will be outweighed by the transaction costs of affecting that change.

[9] Transaction costs in the context of this case include: the parties identifying each other before any speech occurring, symmetric information among the parties about the respective benefits

7 Ronald Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1.

and costs of the speech, the cost of formulating a complete contract to address all possible future contingencies regarding the speech, the fact that one of the parties is potentially violent and menacing, and presumably others still. These transaction costs seem large – indeed, sufficiently large to lead me to conclude that some form of government action is warranted and thus that the Commonwealth's prohibition on the speech considered here serves a legitimate government purpose – namely, achieving the socially optimal amount of the speech.

[10] The question of narrow tailoring is a more subtle one. It requires consideration of other possible regulatory avenues to achieve the legislative objective. Fundamentally, one must consider whether a civil penalty in s 471.12 of the *Criminal Code* would adequately serve the Commonwealth's purpose. I am not convinced that it would.

[11] Many potential defendants facing liability for making the kind of communications at issue in this case in the presence of a civil penalty regime would be unable to pay the requisite penalty. The size of the penalty required to effectively deter the communication would be large and, by virtue of the very nature of the communication,[8] the potential defendant is unlikely to be a person of means. In effect, the civil penalty would not be fully enforced. The penalty is not an effective deterrent if it is not fully payable by the potential defendant.[9]

[12] A further obstacle to the effective working of a civil penalty regime is that persons directly harmed by the speech may not be willing to bring suit. There is uncertainty involved in any lawsuit and legal fees are typically significant. If costs are awarded in favour of the plaintiff, this is resolved *ex post*; however, this is far from certain *ex ante*, when the decision to bring suit is made.

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8 People with significant financial resources may well be able to pursue other avenues both in expressing their views and in attempting to alter government policy.

9 Gary S Becker, 'Crime and Punishment: An Economic Approach' (1968) 76 *Journal of Political Economy* 169.

[13] In addition to these obstacles, the harm caused by the type of communication in this case is not wholly limited to the recipients of the letters. While they may suffer the greatest harm, the communication may be troubling to other parties who suffer a loss either (i) because they feel pain on behalf of the recipients of the letters; or (ii) the mode of communication is an affront to the notion of a tolerant but robust political discourse. Notwithstanding the merits, such a claim would be difficult to establish. Furthermore, the fact that there are multiple parties creates a classic free-riding problem, where each party refrains from bringing suit in order to avoid the costs that accrue solely to them, despite the fact that their actions would benefit other parties.[10]

[14] A prohibition on offensive speech does not seek to balance the benefits and costs of that speech by letting bargaining between the parties or a liability rule lead to some lesser, but non-zero amount.[11] A necessary condition for such a prohibition is that the costs to the audience outweigh the benefits to the speaker. This is a subjective matter best left to the political process. In this instance, however, the fact that the Commonwealth Parliament enacted the prohibition indicates that the political

10 This is a classic problem in a range of economic environments. See, for instance, Bengt Holmstrom, 'Moral Hazard in Teams' (1982) 13 *Bell Journal of Economics* 324 for a non-market setting; and Robert Gibbons, Richard Holden and Michael Powell, 'Organization and Information: Firms' Governance Choices in Rational-Expectations Equilibrium' (2012) 127 *Quarterly Journal of Economics* 1813 for a market setting.

11 The private law analog is an inalienable entitlement. In a sense, the prohibition in this case confers an inalienable right on the families of the soldiers not to be exposed to hurtful and offensive communication. The value of such a right is difficult to quantify which is one reason why a prohibition may be preferable to an attempt at balancing through bargaining or a civil penalty. In the private law context see Guido Calabresi and A Douglas Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 *Harvard Law Review* 1089: 'Another instance in which external costs may justify inalienability occurs when external costs do not lend themselves to collective measurement which is acceptably objective and nonarbitrary. This nonmonetizability is characteristic of one category of external costs which, as a practical matter, seems frequently to lead us to rules of inalienability. Such external costs are often called moralisms'.

branch has deemed the costs to the audience to clearly exceed the benefits to the speaker.

[15] It is natural to ask whether a so-called 'Pigouvian tax' – where the speaker pays for the right to communicate – is a practicable solution. The concerns about monetisability that I outlined above in considering a liability rule apply even more directly to such a tax. As a result, computing the appropriate tax rate seems a daunting task. One might easily conclude that the optimal tax rate is so large as to effectively preclude the speech, in which case it is equivalent to a prohibition. Thus, I conclude that criminalisation of such communication is narrowly tailored.

[16] I am therefore persuaded that any prohibition by the Commonwealth of offensive communications of the kind at issue in this case is reasonably appropriate and adapted to serving a legitimate government purpose as prescribed by the Constitution.

Additional reading

Philippe Aghion and Richard Holden, 'Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?' (2011) 25 *Journal of Economic Perspectives* 181

Gary S Becker, 'Crime and Punishment: An Economic Approach' (1968) 76 *Journal of Political Economy* 169

Bengt Holmstrom, 'Moral Hazard in Teams' (1982) 13 *Bell Journal of Economics* 324