

# Economic Analysis of Law: Incentives and Efficiency Evaluation

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Economic analysis of law has been so wildly successful, particularly in the United States but also increasingly in other nations. Similar to the rabbit in Australia, economics quickly filled a need in the intellectual ecology of law. Consider this traditional description of several types of legislation to help understand the niche a duty that is supported by a governmental penalty is a law. Legislators often inquire how will a sanction affect behaviour? What would happen to the product's price and safety in the future, for instance, if punitive damages were to be awarded to the manufacturer of a faulty product? Or if third-time criminals are sentenced to jail automatically, would crime decrease? Lawyers responded to these inquiries in 1960 in a manner similar to that of 2000 years prior by using their intuition and any relevant information [1]–[3]. Economics gave scientists a way to forecast how punishments in the law would affect behaviour. According to economists, penalties resemble prices, therefore it stands to reason that individuals react to them similarly to how they react to prices. People reduce their use of more costly goods in response to increased pricing, and it stands to reason that they would likewise reduce their participation in sanctioned activities in response to harsher legal penalties.

For analysing the impact of the implicit prices that rules attach to behaviour, economics provides mathematically exact theories price theory and game theory and empirically reliable tools statistics and econometrics. Think of a legal illustration. Let's say a producer is aware that sometimes, customers may be harmed by his goods. The product's safety will he make? The answer relies on three costs for a company that seeks to maximise profits: The first is the price of making the product safer, which is dependent on how it was made and designed; the second is the manufacturer's legal responsibility for customer injuries; and the third is the degree to which consumer injuries deter them from purchasing the product. The goal of the profit-maximizing company is to increase safety until the benefits of lower liability and increased customer demand outweigh the expense of doing so [4], [5]. In general, economics offers a behavioral framework to forecast how people will react to legislation. In the same way that science transcends common sense, this hypothesis surpasses intuition. The public's reaction is always important when creating, amending, repealing, and interpreting legislation.

With regard to societal values, a forecast might be unloaded or loaded. According to research, increasing the penalties for speeding on the roadway should result in less of it. Is this overall positive or negative? The discovery offers no possible solution. In contrast, assume research demonstrates that greater penalties are inefficient since they incur more expenses to collect them than they save via fewer accidents. According to this study, a greater fine would be detrimental. Because public leaders never support squandering money, efficiency is always important when developing policies. This illustration demonstrates that economics also generates loaded forecasts in addition to neutral ones. Judges and other authorities need a mechanism for assessing the impact of legislation on fundamental societal values. Efficiency is achieved using a mechanism provided by economics. In addition to efficiency, economics forecasts how legislation will affect the distribution of income, another crucial value. One of the first uses of economics in public policy was to determine who really pays the costs of alternative taxes. Economists comprehend how laws impact the distribution of income among classes and groups

better than other social sciences. Although virtually all economists support measures that improve efficiency, some economists support a particular side in debates over distribution while others do not.

In the corporate world, earnings are often discussed more frequently than distribution or efficiency. Lawyers spend a lot of their time working to help companies generate more money, particularly by assisting them in contract negotiations, dispute resolution, and regulatory compliance. Transactions, litigation, and regulation are the three activities that correlate to the three practise areas of law in big law firms. The relationship between efficiency and profitability is so strong that attorneys may utilise the efficiency guidelines in this book to assist companies in increasing their bottom line. Economic efficiency is a broad measure of public benefits that takes into account business earnings, consumer prosperity, and worker salaries. The rationale between maximising the whole measure efficiency and one of its components earnings is quite similar. A sound legal framework maintains balance between company success and societal well-being, ensuring that the public benefits from profit-making as well.

A well-known article on law and economics compares the law to a cathedral: a huge, old, intricate, stunning, enigmatic, and holy structure. The mortar that holds the stones of the cathedral together and supports it from all sides is analogous to behavioural science[6], [7]. Although neither the oil corporation nor the manufacturer is able to stop conflict in the Middle East, they may both take safeguards against it. The manufacturing may reserve oil for use in an emergency, and the oil business can arrange backup contracts for the supply of Venezuelan oil. Efficiency calls for the party to exercise caution who can do so at the lowest possible expense. The oil business is perhaps better positioned than a European manufacturer to evaluate the likelihood of co6nflict in that area and take preventative measures because it operates there. In order to be effective, the court can hold the oil firm accountable and reference the rule that stipulated risks would be assigned to the party that can bear them for the least amount of money. This is the least-cost risk-bearer concept.

### **The Primacy of Efficiency Over Distribution in Analyzing Private Law**

Efficiency and distribution are two policy values in which economists excel. Most legal issues have monetary values at risk. Allocating the stakes amongst the parties is virtually always involved in deciding a legal issue. The choice of how much of the stakes each party receives influences future behaviour by providing incentives for both the disputing parties and others in similar circumstances. In this book, we develop predictions regarding the implications of legal judgements, laws, norms, and institutions using these incentive effects. The stakes in a legal battle are divided when a regulation is made, and this impacts everyone in a comparable situation. A judgement in favour of the plaintiff may benefit everyone who consumes the item, invests in the stock, or drives a vehicle if the plaintiff is a consumer of the good, investor in the stock, or driver. However, the majority of advocates for income redistribution have other ideas in mind. Advocates of income redistribution often focus on social groups like the poor, women, or minorities instead of considering distribution to consumers, investors, or drivers.

For the purpose of social justice, some individuals vehemently support government income redistribution by class, gender, or race. Through private law the law of property, contracts, and torts—redistribution may be pursued. To transfer money to worthy groups of individuals, courts should interpret or create private laws, according to this idea. For instance, if average consumer poverty is higher than average investment poverty, then liability laws should be interpreted by courts to favour consumers and disadvantage companies. The redistributive approach to private law is disapproved of in this work. Using private law to further redistributive objectives is an extraordinary application that unique circumstances may warrant, but it shouldn't be the default setting. Why? Read on. Economists argue among themselves regarding redistributive goals, much like the rest of society. In contrast, redistributive methods are largely agreed upon by economists. In contrast to ineffective redistribution, efficient redistribution helps everyone by preventing waste. Effective redistribution increases support for redistribution by preventing waste. For instance, donors are more willing to give to a charity that

effectively distributes funds than to one that spends the majority of its revenues on management[8]–[10].

The state is taken over by social justice proponents who favour redistribution, who then decree that the first oasis shall share its ice cream with the second oasis. A young man is sent sprinting across the desert carrying a huge dish of ice cream from the first oasis to the second oasis in response. The first oasis provides more ice cream than the second oasis does since the intense sun melts part of the ice cream. The price of redistribution is symbolised by the melting ice cream. Even those who fiercely disagree on how much ice cream the first oasis should offer the second oasis may agree that it should be transported by a quick runner. Additionally, they could decide to choose a trustworthy runner who won't consume any ice cream along the way.

Numerous economists think that the tax-and-transfer system, as it is often known, may achieve redistributive aims in contemporary nations more effectively than can be done simply changing or rearranging individual legal rights. Rearranging private legal rights is analogous to offering ice cream to a slow runner for a number of reasons. First, redistribution based on private legal rights depends on sloppy averages, but the income tax clearly targets inequality. Imagine, for the sake of illustration, that judges apply the law so as to transfer revenue from the wealthy to the poor by favouring consumers over businesses. Inadequately, consumers and investors relate to the poor and rich. Customers of Ferrari cars, ski trips, and opera tickets are often very wealthy. A lot of small companies are set up as corporations. In addition, union members who have strong pension plans hold shares in major corporations. Law makes a more accurate distinction between the affluent and the poor when income is taxed progressively rather than indirectly by focusing on consumers and investors.

Second, it is difficult to foresee how shifting private rights may affect distribution. To provide an example, the courts can't be sure that making a company responsible to its customers would make its investors poorer. It's possible that the company may increase prices to cover its greater expenses, in which case the ruling of the court would shift costs from certain customers to other consumers. Third, redistribution via private legal rights often entails large transaction costs. To provide an example, in the United States, a plaintiff's lawyer operating on a contingency fee often charges one-third of the judgement. The lawyers for both parties will split the dispute's two-thirds if the defendant's counsel receives comparable hourly rates. The system of taxes and transfers is more effective.

There is a fourth cause in addition to these three: Progressive taxation does not distort the economy as much as private law redistribution. In general, redistributive policies have less of a distortionary impact when broad-based taxes are utilised instead of legislation with a restricted emphasis. Consider the scenario when a regulation protecting tomato consumers reduces the profit obtained by investors in tomato fields. In response, investors will take their money out of tomato fields and put it into other ventures. As a result, there won't be enough tomatoes available, and prices for them will be excessively expensive. For all of these reasons, economists who support redistribution and economists who oppose it may agree that pursuing distributive justice via private legal rights is often a mistake. Unfortunately, attorneys without an economics background seldom understand these truths.

The economic analysis of law combines two important disciplines and aids in understanding each one separately. You most likely believe that laws serve to further justice; in fact, many individuals are incapable of thinking otherwise. Economics views laws as tools for achieving policy goals efficiency and distribution and as incentives for altering behaviour implicit pricing. However, legal institutions like property and contracts that have a significant impact on the economy are often taken for granted in economic research. As a result, capital markets in Japan, Germany, and the United States are structured differently due to legal variations. The banking crisis of 2008 in the United States and the accompanying recession, which was less severe in Japan and Germany, were both caused by flaws in financial rules and agreements. Additionally, the lack of trustworthy contracts and protected property paralyses the economy of several developing countries. To advance their economies, underdeveloped nations must increase the efficacy of the legal system. Law requires economics to comprehend the behavioral effects of it, and economics need law to comprehend the principles behind markets.

## Microeconomic Theory

Microeconomics is the study of individual and small group decision-making, including that of families, clubs, businesses, and governmental organisations. Microeconomics is the study of how few resources are distributed among competing purposes, as stated in the well-known Lord Robbins quotation at the opening Should you spend your money on that desired digital audiotape player or a sharp suit for your next job interview? Should you study at home this weekend or go on a vacation with some friends? You must make decisions since you have a certain amount of money and time, and as a result, you cannot purchase or do everything you would want to. A broad theory of how individuals make such choices is provided by microeconomics. Our study of microeconomics is divided into five divisions. The notion of customer demand and choice comes first. This theory explains how the ordinary customer makes decisions when faced with a wide range of products and services that are available for purchase. The decisions taken by business organisations or corporations are covered in the second part.

We'll create a model of the company to better understand how it chooses what products and services to make, how much to make, and how much to charge for its output. The final portion will focus on how customers and businesses interact. We will clarify how market pricing changes help companies and consumers coordinate their choices by merging the theories of the consumer and the company. Consumers and businesses must eventually make choices that are consistent, meaning that they can agree on the amount and cost of the item or service that will be produced and consumed. We refer to a market as being in equilibrium when consumption and production choices are congruent in this sense. We'll see that since there are strong factors pushing markets towards equilibrium, efforts to sway the market off its course are typically unsuccessful or even destructive. The supply and demand for the inputs into the production process are discussed in the fourth part of microeconomic theory. Generally speaking, inputs are all the resources that businesses must obtain in order to generate the products and services that customers or other businesses want to buy. These resources include labour, capital, land, and management skill.

### Some Fundamental Concepts: Maximization, Equilibrium, and Efficiency

Economists often believe that each economic actor seeks to maximise something, such as utility pleasure or satisfaction for consumers, earnings for businesses, votes for politicians, revenues for bureaucracies, social welfare for charities, and so on. Most individuals are rational, and rationality necessitates maximization, according to economists, who often claim that models that assume maximizing behaviour succeed. According to one theory of rationality, a rational agent may rate options based on how much they satisfy her needs. The options accessible to the performer are limited in reality. For instance, a rational consumer may rate several bundles of consumer goods, but her choice amongst them is limited by her budget. A sensible customer should choose the best option that the limitations permit.

Recognising that customers choose options that are well adapted to accomplishing their goals is another typical approach to comprehend this view of rational behaviour. The mathematical term for choosing the best option that the restrictions permit is maximising. Consider the fact that actual numbers may be rated from tiny to big, just as a sensible customer would evaluate alternatives based on how much they would satisfy her needs. This will help you understand why. Therefore, greater numbers may be linked to better options. This relationship is referred to by economists as a utility function, about which we will talk more in the sections that follow. Additionally, the restriction on choice may often be quantitatively stated as a feasibility constraint. Selecting the best option that the limitations permit equates to maximising utility function while keeping the feasibility constraint in mind. Accordingly, the customer who shops is considered to maximise usefulness while keeping in mind her financial limitations.

With regard to the second essential principle, economists have a strong inclination to portray every social phenomenon as an equilibrium resulting from the interaction of maximizing agents. A pattern of interaction known as an equilibrium is one that continues until it is interrupted by outside influences. Economists often think that interactions, whether they take place in markets, elections, clubs, sports,

teams, organisations, or marriages, gravitate towards an equilibrium. Maximisation and equilibrium have a crucial relationship in microeconomic theory. Every person's or group's actions are described as attempting to maximise something. Maximising behaviour usually drives these people and communities towards a point of balance or rest. Without a certain, they don't plan for an equilibrium to occur; instead, they just work to maximise their interests in whatever it is. Nevertheless, an equilibrium is often produced by the interaction of maximising agents.

If external forces don't act, the equilibrium will remain stable. As an example, the snowpack in a mountain valley is in stable equilibrium but it can be in an unstable equilibrium at the mountain's top. Unless external pressures cause it to go in a different direction, an interaction that is going towards a stable equilibrium really gets there. In social interactions, external factors often enter the picture before equilibrium is reached. However, equilibrium analysis is justified. The fulfilment of individual desires is the focus of the second kind of efficiency, sometimes known as Pareto efficiency after its creator<sup>1</sup> or allocative efficiency. If it is impossible to improve a condition such that at least one person is better off in his opinion without making another person worse off again, in his opinion, the situation is said to be Pareto or allocatively efficient. Assume that there are just two customers, Smith and Jones, and two items, bread and umbrellas, for the sake of simplicity. The commodities are first divided among them. The distribution is it Pareto efficient? Yes, if it is impossible to distribute the bread and umbrellas in a way that would benefit Smith or Jones without harming the order. Maximisation, equilibrium, and efficiency are the three essential ideas that underpin all explanations of economic behaviour, particularly in decentralized institutions like markets where the coordinated interaction of several individuals occurs.

### Consumer Preference Orderings

An analysis of customer preferences forms the basis of the economic model of consumer choice. Consumers are presumptively aware of their likes and dislikes and capable of ranking various alternative combinations of products and services in accordance with how well they can meet the consumer's preferences. This only entails classifying the choices as superior to, inferior to, or equivalent to one another. Indeed, some economists hold that what an economist understands by the word rational is the constraints they place on the ranking or ordering of customer choices. What are these circumstances? They require that the ranking or ordering of a consumer's preferences be comprehensive, transitive, and reflexive. Simply put, the customer must be able to communicate her ranking of all potential combinations of products and services for an order to be considered complete. Let's imagine that A represents a bundle of certain products and services and that B represents a second bundle, but in a different quantity, of the same goods and services. For a purchase to be considered complete, the customer must be able to state whether she prefers A to B, prefers B to A, or believes that both A and B are equally excellent i.e., she doesn't care whether she buys A or B. The customer is not permitted to claim that they cannot be compared.

A mysterious aspect of customer preferences is reflexivity. It implies that every collection of items, A, is at least as excellent as it is by itself. It is challenging to provide a reason for the inclusion of that condition since it is trivially true. The preference ordering must abide by the following constraint in order to be transitive. A must be preferred over C if bundle A is preferred over bundle B and bundle B is preferred over bundle C. This also holds true for indifference: If a customer is undecided between options A and B and between options B and C, she is likewise undecided between options A and C. Individual preferences cannot be circular due to transitivity. Transitivity, therefore, indicates that A cannot be preferred to B, B cannot be preferred to C, and C cannot be preferred to A. The majority of us would likely consider someone with circular inclinations to be exceedingly young, immature, or insane.

### The Profit-Maximizing Firm

The organisation where inputs money, labour, land, etc. are converted into outputs products and services is known as a business. We assume that businesses maximise profits subject to the limits placed on them by consumer demand and manufacturing technology, just as we believe that consumers

rationally maximise utility subject to their income constraint. Profits are outlined in microeconomics as the difference between total revenue and the sum of all manufacturing expenses. The sum of the production units sold times the price per unit is the company's total revenue. The sum of all input costs, multiplied by the number of input units utilised, equals total costs. The quantity of production that results in the biggest favourable differential between the business's income and expenses is what the profit-maximizing firm creates. According to microeconomic theory, a business will maximise its profits if it generates the quantity of production where the marginal cost and marginal income are equal. Actually, this is just a particular case of the basic principle we mentioned in section IV.D earlier: To reach an optimum, equalize marginal cost and marginal gain.

These arguments argue that the company should increase output when marginal revenue exceeds marginal cost, and cut production when marginal cost surpasses marginal revenue. Profits will, therefore, be at their highest for an output for which both marginal cost and marginal income are identical. Take note of this rule's economy: The company may experiment with production unit by unit to find the output level that maximizes its profitability rather than worrying about its total costs or total revenues in order to maximise earnings.

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