Economic Analysis of Law in European Legal Scholarship 1

Klaus Mathis *Editor*

Law and Economics in Europe

Foundations and Applications

Springer

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Economic Analysis of Law in European Legal Scholarship

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Foreword

"Law and Economics" is one of the growing number of "double-barrelled subjects", such as Legal Philosophy, Legal Sociology, Legal Psychology and Legal Anthropology, which connect law with other disciplines. These "double-barrelled subjects" contribute to the trend towards interdisciplinarity. The subject perspective is increasingly criticized for being too narrow. Disarming this criticism is no easy task. "Double-barrelled subjects" and interdisciplinarity call for relevant subject competence. Those who weigh in on the academic discourse in more than one discipline soon find that doubts are cast on their competence. Formal double qualifications in two or more disciplines provide legitimation, as does collaboration with experts from different disciplines.

The conference on "Law and Economics" held in April 2012 at the University of Lucerne, the papers from which are published in this volume, was a gathering of such individuals; while some hold double honours degrees, others are engaged in cross-disciplinary collaboration in law and economics. This laid the best possible foundations for making the resulting contributions to the "double-barrelled discipline" of "Legal Economics" robust to criticism. Nevertheless, the challenge was considerable, not least because the economic difficulties in many countries demand explanations from the discipline of Economics. In fact – rightly or wrongly – Economics is held jointly responsible for these difficulties. In the given circumstances, should Law have anything to do with this discipline? A resounding "yes" is the answer. Economics as a discipline, its very right to exist, its necessity, its usefulness and its further development cannot seriously be called into question.

The "Law and Economics" conference also deserves gratitude and appreciation for its commitment to the "Europeanization" of Law and Economics. It is indeed a worthwhile endeavour to loosen dependency on the US-American tradition as well as problems and solutions framed from a US perspective. The editor of this volume wants to go even further. With this publication he starts a new academic book series entiled "Economic Analysis of Law in European Legal Scholarship" (EALELS) which is dedicated to Law and Economics from an European perspective. I am confident that this new series will encourage further research in the field of European Law and Economics.

The University of Lucerne has an eminent interest in conferences of this kind. They yield a fresh view of trans-disciplinary lines of questioning and, accordingly, the possibility of differentiated answers. Of course, disciplinary competence remains indispensable for all participants and must take precedence. At the same time, however, it is increasingly important to build bridges between neighbouring disciplines, since interaction between them augurs new advances in knowledge.

"Double-barrelled disciplines" can be approached from either discipline. Therefore, the questions, methods and answers do not always coincide completely and may also diverge, depending on the strengths of the questioners and answerers.

The University of Lucerne is interested in "double-barrelled disciplines" not only in Law but in other fields, too. For instance, "Philosophy and Management" and "Philosophy and Medicine" are courses offered at our Faculty of Humanities and Social Sciences as postgraduate programmes aimed at practitioners of management and medicine, respectively. These specialists will find their vision considerably broadened by the "double-barrelled subject", resulting perhaps in a higher level of reflective skills. The University of Lucerne also offers an interdisciplinary Master's degree in "Religion – Economy – Politics", in which students with Bachelor's degrees from any of the three disciplines are taught by faculty with the requisite specializations. The students' enthusiasm is proof enough that such programmes considerably enrich disciplinary degree courses.

Returning to this volume, it is to be hoped that it will meet with broad interest and inspire specialists in both disciplines as well as interdisciplinary "Law and Economics" colleagues to explore new ideas and avenues. This would be the finest recognition for the commitment and enthusiasm of the organizers of the "Law and Economics" conference and the publishers of this volume.

Lucerne
September 2013

Prof. em. Dr. Paul Richli
President University of Lucerne

Preface

This anthology, *Law and Economics in Europe. Foundations and Applications*, arises from two conferences: the Special Workshop that took place at the 25th World Congress of Philosophy of Law and Social Philosophy (IVR) in Frankfurt a.M., from 15 to 20 August 2011, and the 1st Law and Economics conference from 20 to 21 April 2012 held at the University of Lucerne. The thematic scope of this volume spans both the theoretical and practical developments of "Law and Economics" in European countries with a Civil Law tradition. Since all of the chapters are written by authors from Europe, they reflect a specifically continental-European perspective on these themes. One of the main intentions behind the publication of this volume, therefore, is to make this point of view accessible to an English-speaking readership.

I take this opportunity to thank all the people who have contributed to the successful completion of this book. First of all, I thank Deborah Shannon for her usual meticulous translation of my chapter, as well as those by Ricardo Dawidowicz, Balz Hammer and Sandra Duss, and Zinon Koumbarakis. I also thank Assistant Professor Lauren Fielder, J.D., LL.M., Lynn Watkins, MLaw, Ariel Steffen, lic. phil., and Silvan Rüttimann, MLaw, for their diligent proofreading. A special thanks goes to the Swiss National Science Foundation (SNSF) as well as to the Research Commission (FoKo) and the primius programme of the Law Faculty of the University of Lucerne for financing the conference in Lucerne and supporting the publication of this anthology. Finally, I am grateful to the anonymous reviewers for their helpful comments as well as to Neil Olivier, Diana Nijenhuijzen and Corina van der Giessen at Springer Publishers for overseeing the publishing process, and to Sundarajan Chitra and her team from SPi Content Solutions for the careful typesetting.

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Klaus Mathis

Contents

Introduction

This anthology illustrates how "law and economics" is developing in Europe and what opportunities and problems – both in general and specific legal fields – are associated with this approach within the legal traditions of European countries. On the one hand, this anthology intends to explore both the methodical and philosophical foundations of the economic analysis of law. In doing so, the theories of economics (mostly the principles of microeconomics and welfare economics) will be analysed and the methods behind empirical social research will be critically reviewed. The findings of behavioural economics, which have called into question the basic assumptions of economic theory – for example the rationality or the selfishness of players – are also of great significance in this debate. On the other hand, the question of why the economic analysis of law has developed differently in Europe than in the USA will also be discussed. The lawfulness of consequence-based reasoning in law application may have played an important role in this discrepancy. Furthermore, it shall be shown in which fields of law economic-based reasoning and methods have – explicitly or implicitly – found their way into continental European law. Therefore, the main intention of the book is not to further explore economic analysis as such, but rather to focus on the implementation of economic methods in legislation and adjudication from a European perspective and to take into account the particular challenges the European legal systems face.

The economic analysis of law explores legal questions using economic methods. In doing so, it is confronted with several intersection points: on the one hand, the intersection between the two disciplines (law and economics) and, on the other hand, the intersection between Civil Law and Common Law – as law and economics, at least partially, rests on the reception of ideas from US American legal culture. A third intersection point lies between facts and norms, positive and normative theory. All of these intersections pose multifaceted challenges for the economic analysis of law. First, the interdisciplinary approach of law and economics requires a high level of in-depth knowledge of both disciplines. Furthermore, it demands the ability to reflect on a meta-level which findings from economics could reasonably be transferred into the law. The challenge faced by jurisprudence and legal philosophy, therefore, is to identify the viability of an economic approach in law and to examine

it critically. Unfortunately, in the academic world it is often hard to work in an interdisciplinary way due to the increased pressure to specialise, which can cause a grave problem for scholars researching in this field. The second intersection, between Civil Law and Common Law, poses a further challenge for European legal scholars. In the earlier days of law and economics, research within Europe consisted more or less of a plain reception of American literature. However, I am of the decisive opinion that the time has definitely come to found and cultivate our own European style of law and economics, instead of just continuing the uninspired citing of US-American literature and ideas. Finally, the intersection between facts and norms is particularly tricky for legal scholarship. The fundamental question posed here is how to incorporate the empirical findings from economics and the social sciences in general into legislation and the application of the law. Closely related to this problem is the specific question of the admissibility of consequence-based arguments in legal reasoning.

This anthology deals with these three intersection points, not just on a theoretical level, but also through the use of examples found in practice. It consists of the following four parts: Part I: Civil Law versus Common Law; Part II: Economic and Legal Thinking; Part III: The Limits of Legal Transplants; Part IV: Economic Analysis in EU Law. Part I illuminates the differences in the development and reception of the economic analysis of law in the American Common Law system and in the continental European Civil Law system. Even though the methods of economic analysis are the same – in particular the devices of the microeconomic theory – the concrete applications and the problems these pose are subject to the legal and cultural context. Part II focuses on the different ways of thinking of lawyers and economists, which clash in the economic analysis of law. The legal culture plays an important role here as well, as the respective methods of legal reasoning can be more or less compatible with economic analysis. Part III is devoted to legal transplants, which often accompany the reception of law and economics from the USA. The problems that arise from such direct adoption of foreign legal institutes – particularly from a constitutional law point of view in European countries – are discussed using concrete examples such as Class Action or lenience programmes. Finally, Part IV focuses on the role economic analysis of law plays in the European Union. Both the theory as well as concrete examples – for instance the "more economic approach" in antitrust law – are analysed.

Part I starts with the contribution, "Never the Twain Shall Meet? A Critical Perspective on Cultural Limits Between Internal Continental Dogmatism and Consequential US-Style Law and Economics Theory", by Kai Purnhagen. It discusses possible explanations for the difference in receptiveness to law and economics between the USA and Europe. The author focuses on cultural factors that have influenced both the division of approaches (during the first wave) as well as the coming closer of the theories propagated in Europe and the USA (during the subsequent second wave). Prior to World War II, the classic legal thinking and especially the non-consequentialist thinking was the prevailing view in both Europe and the USA. However, on both continents there were schools of thought which rejected classic legal thinking. Legal Realism as established by Oliver Wendell

Homes in the USA and the free law school in Europe is discussed as having a parallel impact on classic legal thinking. The first wave is described as the post–World War II era in which law and economics theory became the dominant theory in the USA while Europe was dominated by classic legal thinking. While commonly explanations for this divergence are sought in the different legal education system and the different role of courts, the author argues that cultural influences also play an important role. In the USA, the cultural influences discussed focus on two main factors: the intellectual persuasive development and the strong financial support by the Ohlin foundation. The author sees the appointment of economist Henry Simons at the University of Chicago law school as the beginning of the intellectual movement. The reception of Posner's "Economic Analysis of Law" and the subsequent debate between Calabresi and Posner, it is argued, are the factors which led to the dominance of law and economics in the USA and therefore represent the central factor in the intellectual persuasiveness of the law and economics movement. John M. Ohlin had the explicit goal to introduce free-market thinking into American law schools. By funding the founding of the law and economics Center by Henry Manne through the Ohlin foundation, he gained an ideal vehicle to reach his goals. The focus on classical legal thinking in Europe is argued to be the result of the need to digest the horrors of the Nazi-regime. According to the author, this meant that a greater level of importance was placed on constitutional law as a means to achieve and protect basic and unalienable rights for all individuals. The author does describe some slight growth of the law and economics movement by the Ordoliberal School funded by the Walter Eucken Institute. However, he does not view the theories propagated by the Ordoliberals as comparable to law and economics and makes clear that the Walter Eucken Institute did not have the same financial power as the Olin Foundation. The author describes the second wave as the beginning of a convergence of thought between the two continents and this trend appears to follow on the fall of the Berlin Wall. During this time, the USA has moved towards more classic legal thinking resulting from the "new formalism" movement that strongly challenged the law and economics movement. In Europe, however, the dying off of the World War II generation and the introduction of financial institutions which support legal scholarship in the USA is seen as the main cultural influence on the strengthening of law and economics.

Régis Lanneau's chapter, "To What Extent Is the Opposition Between Civil Law and Common Law Relevant for Law and Economics?", aims to answer the question to what extent the difference in legal architecture is relevant for the reception of law and economics. The author begins his analysis with the comparison between Civil and Common Law and uses the crude distinction of these two different systems as they developed historically and how the different agents of the law may apply economic theories. He then shows that the differences between these two legal structures has over time begun to blur, leading to an extension of the different agents in law who may use law and economic analyses and can no longer explain why law and economics has been received so differently, not just between Civil and Common Law systems, but also between the nations using the same legal system. His conclusion is that the Civil versus Common Law division is an insufficient

differentiation when trying to explain the varying degree that law and economics has been accepted in the different legal systems. Lanneau's theory on the difference of the reception of law and economics relies on three legal characteristics: (1) perceived instrumentality of law, (2) autonomy of legal reasoning, and (3) the perceived freedom of judges. He argues that the more the law is perceived as being a means to an end to achieve some general social purpose, the more acceptable it appears to apply economic theories and tools when trying to assess the consequences of a legal rule or institution. With regards to the autonomy, of legal reasoning, Lanneau argues that the greater the perception of autonomy the less likely economic theories will be applied, since autonomous legal reasoning sets out the requirement that the answer should be found using the law and legal arguments alone. Likewise, the greater the discretionary powers of judges the more likely economic theories will be applied, as the economic analysis and tools provide the judge with justifications for his arguments, especially in systems which promote pragmatism in judicial reasoning.

In her "Comparative Study of Legal Reasoning in Swiss and UK Courts. Illustrated by Health Care Rulings", Lynn Watkins discusses the differences between approaches the Swiss Federal Court and the UK High Court take with regards to economic analysis as applied in health care rulings. The author begins by discussing the obligation on a state to provide access to primary health care. This requires health care policymakers to not only consider clinical effectiveness of a treatment but also cost-effectiveness. The use of quality added life year (QALY) for the purpose of assessing cost-effectiveness of a given treatment is highly controversial. However, its application is standard and part of the law in the UK. In Switzerland, the legislator simply stipulates that treatments must be cost-effective, but the Court must devise its own methodological approach on how to define cost-effectiveness. Against this background, two cases – one from the UK and one from Switzerland – are analysed to see how the Courts approach economic arguments. In closing, the author discusses possible reasons for the different approaches.

Part II starts with Mariusz Golecki's chapter, "Homo Economicus Versus Homo Iuridicus. Two Views on the Coase Theorem and the Integrity of Discourse Within the Law and Economics Scholarship". He discusses the different aspects of legal discourse and compares the approaches taken in the discipline of law and economics in the USA and Europe, respectively. According to the author, the tension between the American law and economics and the European economic analysis of law is in part a reflection of the tension between the pragmatic (functional) approach and the descriptive (analytical) approach of linguistic categorization of law. The central question in this chapter is whether there has been or can be a paradigm shift from a more descriptive approach to a more functional approach to linguistic categorization. To do so, he investigates the similarities and differences between legal and economic discourse in law and economics between Europe and the USA and uses the Coase theorem as a central point of investigation. Golecki then outlines and discusses the problems surrounding the Coase theorem and the associated explanations. Through means of Halpin's direct and indirect models, the author highlights that direct modelling based on the assumption that law is subject to

the scarcity of resources which brings economics into law. While this plays an important role in the economic analysis of law in Europe, in the USA, an indirect model plays an essential role in the law and economics movement following a more methodological approach. These two different approaches are then discussed by the author, first the European approach and subsequently the US approach. He first describes the framework of the economic analysis of law as a traditional descriptive discourse using a direct model. He discusses the relationship between the law and economics model of decision-making and the institutional structures in place often reflected in the interpretation of the Coase theorem proposed in Europe. In comparison to the direct model, the author describes the indirect model-based discourse found in the USA, where at the centre of the methodical approach lies the assumption of homo economicus. Both models are based on assumptions of a particular theory of human behaviour aimed at accomplishing certain aims and therefore, subjectively, can be seen as being placed within the sphere of decision making. This is what causes a link between the two models or is the point at which the homo economicus – based approach and the homo iuridicus – based approach meet.

In his contribution, "Three Realistic Strategies for Explaining and Predicting Judicial Decisions", Diego Moreno-Cruz presents three strategies used to explain and predict judicial decisions. These include: (1) the economic approach, (2) the psychological approach, and (3) the naturalistic approach. The first two of these are teleological explanations or rationalizations while the third strategy is a mechanical explanation or natural causation approach. The mentioned strategies are then compared. According to Moreno-Cruz, the strategies differ in two aspects: (1) they are based on different assumptions, and (2) they are based on different theories. They are, however, compatible in four different aspects which also characterize American Legal Realism. These are: (1) causal explanation, (2) ontological and epistemological beliefs, (3) predictive-theoretical objectives and products, and (4) the personality of the judge as the determinant of the judicial decision. At the end of this chapter, the author discusses Brian Leiter's basic epistemological option. According to Leiter, one must choose between either the psychological approach or the naturalistic strategy but reject the economic approach. To make this choice, one must, (a) prefer the psychological approach to the economic approach, and (b) prefer the naturalistic approach to the economic approach. The author argues that Leiter's epistemological approach is unfounded from a pragmatic point of view. The rejection of the economic approach in favour of either the psychological approach or the naturalistic approach is unfounded because each of these strategies is different in nature and provides different results. The three strategies are complementary and, therefore, not interchangeable. In his opinion, the economic approach is an adequate strategy for explaining and predicting judicial decisions, especially in commercial disputes, due to the pragmatic utility criterion of availability. He concludes that an epistemological pragmatic decision, to either reject or prefer one approach over the other, must be based on evidence regarding predictive failures and successes. Failing the availability of such evidence, it is acceptable to recognize all three approaches as realistic, complementary, and useful strategies.

In his chapter, "Some Thoughts on Economic Reasoning in Appellate Courts and Legal Scholarship. With Norwegian Illustrations in Three Legal Dimensions", Endre Stavang shows how economic analysis of law has gained popularity and recognition within the Norwegian legal community. He describes three instances in which Norwegian courts have applied economic analysis in their reasoning and introduces three publications by Norwegian scholars within the field of law and economics to illustrate his case. The three legal cases Stavang discusses range from contract law questions to tort law and copyright infringement. In the contract law case, the example used is of an apartment sale, in which the reasoning of the court's decision clearly allocated the legal burden to the seller with a view to create incentives for the contracting parties to reduce transaction costs as a result of the ruling. In the second tort law case, economic theories of human capital and production theory were applied to recover the loss of salary and dividends as a result of a road traffic accident. Finally, the author discusses the famous copyright infringement case commonly known as the DVD-Jon case. In his opinion, this is a good example due to the inclusion of expert testimony regarding the market effects of sharing a programme on the Internet allowing individuals to circumvent the DVD Content Scrambling System. Furthermore, though sparse, the court ruling does appear to conduct a cost-benefit analysis. The first of the scholarly works from Norway the author discusses is Trine-Lise Wilhelmsen's monograph, which analyses how the Norwegian Contract Formation Act contributes to economic efficiency. The second work he discusses is Hans Christian Bugge's monograph on environmental civil liability. In this book, the "polluter pays principle" is reviewed and a detailed analysis of the law in view of the ecological goal, the economic goal and the legal goal is made. The final paper the author highlights is the work of Gunner Nordén on the legal regulation and stance of the Norwegian Central bank. These three scholarly works are used to highlight the level of ambition and openness to the interdisciplinary approach of law and economics in Norway. However, this interdisciplinary approach does raise a demarcation problem between law and economics. According to the author, economics is often already embedded in legal problems, thereby requiring legal scholars to also discuss the economics associated with their subject matter. Furthermore, the author argues that there is no need for a protectionist stance, as the professional world will naturally determine what will and will not survive. The three approaches to law and economics described by Anthony Ogus are then used as a guideline for conducting such interdisciplinary scholarship in the future. To further alleviate the worries regarding the potential problems associated with the transformation of economic reason to legal arguments, the author describes three mechanisms through which sources of law may support the socially desirable solution to legal problems; they are, (1) the prevalence of private autonomy, (2) the internalization of risk and harmful effects, and (3) the balancing of interests. The strong tradition of legal realism and pragmatism found in Norway may provide the bridge between law and economics other European jurisdictions lack.

In his chapter, "Cultures of Administrative Law in Europe: From Weberian Bureaucracy to 'Law and Economics'", Klaus Mathis shows how economic theories

have enriched and influenced administrative jurisprudence and the culture of administrative law in Germany and Switzerland. Starting out from Weber's model of bureaucracy, he describes, and critically appraises, the influences of both the economic theory of bureaucracy and transaction cost theory on new administrative law paradigms such as New Public Management, Steering and Governance. Whereas Weber presupposed a common rationality that systematic legal systems needed to be based upon, new administrative law is based on value pluralism, governing the different values by formalizing the interactions between players instead of the formalization of values. By doing so, it switches administrative law from top-down regulation based on value monotony to process-oriented networks based on value pluralism. In modern European welfare states, state action not only has to be constitutionally correct as in liberal states, but must also be conducive to establishing distributive justice. Furthermore, in view of increasingly tight state finances, the efficiency of state activities becomes a requirement of ever-increasing importance. Even if justice and efficiency are frequently in conflict with each other, they nevertheless have one thing in common: the instrumental and consequential orientation. This entails greater instrumental programming of administrative law, in contrast to the traditional approach of conditional programming as described by the Weberian model of bureaucracy that was mirrored in reality in the liberal constitutional state. Instrumental programming, moreover, and the administration's concomitant responsibility for consequences call for insights from other disciplines in order to be able to predict and evaluate the real consequences of state action. It is therefore no coincidence that new theories of administrative law – New Public Management, New Administrative Law scholarship, and governance – have a pronounced interdisciplinary tendency and draw quite substantially on concepts and insights from the field of economics. At the same time, a change in administrative law culture can be observed: modern administrative law governs value pluralism by the formalization of interactions between players instead of the formalization of values, and traditional hierarchical regulation is supplemented by cooperative control structures such as networks. This is how modern administrative law tries to provide a framework for the various ways of life and opinions present in a multicultural and globalized society.

After these more theoretical parts, Part III is devoted to the more practical question of the limits of legal transplants one is confronted with when US-American legal institutes are adopted into European law. In their contribution, "The 'Hand Rule' as a Standard of Care in Swiss Tort Law?", Balz Hammer and Sandra Duss research the question as to whether the Hand rule can be applied in Swiss tort law as a standard of care. Before they elaborate on this concept, they point out the important differences between the legal and economic understanding of tort law. While lawyers focus more on the idea of compensation and justice, economists focus primarily on efficiency paradigms. The latter aim at assessing a tort case in such a way as to find the most cost-effective result for society as a whole, thereby maximising the social welfare. This aim is fulfilled by the application of the Hand rule, which the authors subsequently elucidate and critically assess. According to this rule, someone acts negligently if the expected cost of a damage caused by

him or her is greater than the cost of avoiding the damage. From an economic analysis of law perspective, this rule will always result in an efficient solution if both the injurer and the injured are able to take precautionary measures, as this will create an incentive for both sides to take cost-effective precautionary measures. The traditional legal standpoint counters this idea with the argument that the main purpose of tort law is to re-establish justice between the affected parties, and not in the pursuit of maximization of social welfare. Aside from the justice argument, legal authors discuss further problems – for example, the high information and administrative costs or the bounded rationality of the actors – which can occur when the Hand rule is applied. Finally, Hammer and Duss analyse a selection of cases from the Swiss Federal Court. In doing so, they ascertain that some elements of the Hand rule can be found in Swiss tort law – namely, when ruling on fault-based liability and in some instances of simple causal liability.

Ariane Morin discusses in her chapter "Efficiency and Swiss Contract Law" the role of the efficiency principle in Swiss contract law. Based on the assumption that efficiency is the basis of contract law, economic analysis of law has two functions: (1) a descriptive function, and (2) a normative function. Both of these functions can be used in either a theoretical approach or doctrinal approach. The theoretical approach, however, is not one found in Europe. In it, the principle of efficiency is considered regardless of the influence of the legislator's will. A more common approach is a doctrinal one. Here, the basis of civil contract law is the ideal of efficiency as a leading principle. This allows for both the normative and descriptive function to play an important role. The descriptive function acts as a guide for the interpretation of law, while the normative function helps to create new legal rules. The general receptiveness of a civil contract law code to economic analysis of law is dependent on context and values of the legal system into which the idea of efficiency is to be imported. After all, in the author's opinion, the idea that efficiency should be the goal of a law is nothing more than a belief. The characteristics of Swiss private law discussed are twofold. Firstly, the author describes the historical development of the Swiss Civil Code and highlights that it has always been heavily influenced by other legal systems, including Germany, France and Austria. The Swiss Civil Code has then influenced many other legal systems. As examples, the author cites the total reception of Swiss Civil Code in Turkey in 1929, as well as its strong influence in Mexico. Secondly, the flexibility of judges, which is very important for the doctrinal approach, is described. Judges are given a canon of interpretation methods they must use to find the *ratio legis* of a law. As the Swiss Civil Code is based on the idea that the code should be both popular and democratic, there is a greater focus on the textual interpretation of the law. The Swiss Civil Code concept was such that it should be easily understood by a layperson. For this reason, the law needs to be precise enough to settle an individual dispute and still be general and abstract enough to apply to all. This approach, however, means that the code is incomplete. The resulting gaps must be filled by the judges through the creation of general and abstract rules. This filling of gaps gives judges a relative degree of flexibility. However, the principle of legality requires judges to obey the choices made by the legislator in his interpretation, thus, any new rule created to fill a gap

must take into account the values and the system as a whole. Swiss contract law does not explicitly state that efficiency should be the goal. Rather, the principles of freedom of contract and good faith can run contrary to the ideal of efficiency. Only if the ideal of efficiency coincides with both of these principles, may a judge consider it in his ruling. Despite this limitation, there is some room for efficiency-orientated thinking in Swiss contract law. Firstly, efficiency may be applied by the judges in the subjective criterion if it appears that both parties clearly wanted to reach an efficient solution. Secondly, the judge must take efficiency into account when there are special legal rules to which the contract is referring to. An example is the Federal Act on Cartels.

The chapter of Ricardo Dawidowicz, "Class Action Lawsuits in Europe: A Comparative and Economic Analysis", focuses on possible structures for class action lawsuits in Europe. The author begins with an analysis of collective legal protections options in Europe in the form of collective lawsuits. These collective lawsuits have certain advantages particularly in areas of dispersed harm or in instances of mass harm. There are two possible structures of the collective lawsuits: opt-in and opt-out. Under an opt-in procedure, affected third parties must expressly confirm their intent to participate in the procedure, while in opt-out procedures, third parties must expressly declare their withdrawal. Next, the US-style class action is described and analysed. Rule 23 of the Federal Rules of Civil Procedure introduced class-action lawsuits in 1938. Its aim was to group the interests and resources of people with claims based on the same or similar causes addressed to the same person, thereby making the class action a representative lawsuit. The author then describes the effects of punitive damages, which he argues create a climate favourable to the plaintiffs. A further difference to the collective lawsuits and the class action in the US is seen in the "American Rule", whereby the losing party pays the court costs but the lawyers' fees must be paid by the parties. This is in direct contrast to the "English Rule" practiced in Europe, whereby the losing party must cover all legal expenses. A final aspect analysed is the impact contingency fees have. The author describes the relatively new instruments for collective legal protection found on a national level in Europe. Here, he describes the German "Capital Investors' Model Proceedings Act", which was implemented on a trial basis; the Group Litigation order in England which was introduced in 2000; the new code of civil procedure in Spain, which introduced a hybrid from between-group action and proceedings brought by an association within the sphere of consumer protection; and the Swedish class action, which was introduced in 2003. On the EU level, despite much debate and even quite a few proposals, there is currently no collective legal protection in place. Conducting cost-benefit analysis is generally acceptable in legislative procedure but very controversial in adjudication. In class action lawsuits, the efficiency benefits are also measured by their deterrent effect. However, the author argues that due to economies of scale, the defendant of a class action lawsuit gains an unjustified advantage as he need only clarify the question of law or fact once. According to the author, class action lawsuits are procedurally more efficient. This efficiency is due *not only* to economies of scale but also due to the lower court costs when compared to dealing with numerous individual cases.

Furthermore, the frequent out-of-court settlements increase procedural efficiency. The dispersion of costs of a trial among many individuals who have a vested interest results in a reduction of each individuals' costs and also helps to disperse the risk. This results in an increased willingness and number of lawsuits filed, which in turn has a greater deterrent effect, and is seen as a further argument in support of class action lawsuits. Despite these advantages and benefits, there are clear problems associated with class action lawsuits. First, the issue of sweetheart settlements is discussed. These settlements result from the conflict of interest between the group lawyer and the group she represents. However, the role of contingency fees in sweetheart settlements is heavily debated. Secondly, there is a fear associated with class action lawsuits centring around the possibility that there will be many frivolous or extortionate claims. In closing, the author offers three possible solutions to the problems raised: firstly, by introducing tighter control by group members to reduce the risk of sweetheart settlements, similar to the principle-agent problem; secondly, by subjecting out-of-court settlements to judicial scrutiny; and finally, by including the possibility of auctions of class action lawsuits.

In his contribution, "Crown Witnesses in Switzerland? The Crown Witness in the Dialectical Tension Between Security and Rule of Law", Zinon Koumbarakis discusses the problems surrounding crown witness provisions in Swiss law. The author begins his discussion by outlining the needs and purpose of crown witness provisions. In particular, he describes the necessity of such provisions in investigations. Next, the various provisions within Swiss law are highlighted and discussed. First, the criminal law provision is discussed, which is limited to punishable acts in connection with criminal organizations. The second provision discussed is Article 13 of the Federal Act on Administrative Criminal Law, by which offenders avoid punishment if they report their own contravention of a payment or repayment obligation. Finally, the author describes the antitrust law provisions, which allow the Swiss Competition Commission to dispense in part or in whole with direct sanctions against an enterprise that cooperates in the uncovering of a cartel. These crown witness provisions may lead to a competition between the crown witnesses comparable to the prisoners' dilemma. This dilemma describes an incentive structure that will either inhibit or jeopardize the collaboration between crown witnesses. The comparison between the prisoners' dilemma (as described in economics) and crown witness regulation is discussed at length, but the author concludes that this alone cannot provide a reliable prediction of the behaviour of a crown witness in advance. The author proceeds by describing the background and legal position of plea agreements. The basis of such agreements is a confession in return for leniency in sentencing. Such plea agreements between prosecuting authorities and the accused are not found in Swiss law. The closest thing to the classic Anglo-American "plea bargaining" is the "abbreviated procedure". However, there are many ingress points for the introduction of plea agreements, in particular the "principle of opportunity". The main dialectical tension, according to the author, lies between security and the rule of law. The arguments in favour of a crown witness provision include: investigative necessity, efficient use of available resources, destabilization effect, offender's perspective, cost, and legal reality. The

arguments against a crown witness provision are: the misgivings regarding the rule of law, effectiveness, structure of criminal procedure, ideal of justice, moral argument, and psychological stress. According to the author, these tensions can be resolved by means of a balancing test.

Finally, in Part IV European law is discussed. Aurélien Portuese begins with a theoretical contribution to the topic with his chapter "The Case for a Principled Approach to Law and Economics: Efficiency Analysis and General Principles of EU Law". He argues that the principle of economic efficiency underpins all general principles found in EU law, and that economic analysis of EU law should take a principle-based approach rather than the current approach focusing on legal rules. He begins his argumentation by discussing the limitations of legal nihilism, which denies legal principles in favour of legal rules that encapsulate efficiency as proposed by Posner. Next, the Posner-Dworkin debate is discussed and the core issue is identified as the role of the judge in the law-making process, that is to say, the range of judicial discretion that judges (should) have. However, these represent top-down approaches, and so a more bottom-up approach away from legal rules and focusing on legal principles as bundles of sub-principles/rules is a better approach, according to the author. For this purpose, the author discusses three principles: the principle of subsidiarity, the principle of proportionality and the principle of legal certainty. The author describes the economic foundations underlying these principles and shows how the EU Court has applied and crystallised these principles. The first principle discussed is the principle of subsidiarity, which governs the exercise of EU powers shared by means of treaties by Member States with the EU institutions. Enshrined in Article 5.3 of the TEU, an EU institution which has shared competence, may only act subsidiarily to the member state. This decentralization delivers efficiency gains, which are threefold: (1) superior variety of regulations, (2) a greater disciplinary effect, and (3) the encouragement of innovation and experimental strategy. Through analysing case law from the ECJ, the author views that this principle of subsidiarity results in EU judicial self-restraint, which is an optimal strategy to minimize judicial error costs. Second, the principle of proportionality is central to EU judicial reasoning and is discussed from the viewpoint of efficiency. According to the author, both the cost-benefit analysis of possible legal consequences and its mere existence in EU treaties are enough to support an efficiency approach to this principle. His reasons are discussed at length before turning to a comparison between the US Supreme Court's jurisprudence and the ECJ cases, proving the necessity of such an approach. Finally, the author discusses the principle of legal certainty. There are three legal requirements stemming from this principle: (1) determinacy and predictability of the law, (2) delayed implementation of the law, and (3) legal coherence. The principle of legal certainty from an efficiency perspective carries the following three social costs: (1) transaction costs, (2) reliance costs, and (3) risk costs. This efficiency-based understanding of the principle of legal certainty is found in many ECJ cases discussed by the author. In closing, the author argues in favour of a more principle-based approach as it is more illustrative of the practice of the courts, and because it makes economic analysis of law more accessible to "traditional" lawyers.

The chapter "Homo Economicus, Behavioural Sciences, and Economic Regulation: On the Concept of Man in Internal Market Regulation and its Normative Basis" by Jens-Uwe Franck and Kai Purnhagen analyses the concept of man that EU law and the ECJ have with regards to internal market regulations and their normative basis. The key ambition of the EU is to create a well-functioning internal market. The "better regulation" strategy has made unambiguously clear that in order to achieve this internal market, economic analysis of regulations aiming to enhance allocative and dynamic efficiency is vital. The authors explain that the debate surrounding behavioural sciences and their possible influence on regulation must not be ignored by regulators when employing economic expertise when trying to achieve this "better regulation". First, the authors describe the "information model" that has gained importance since the "Cassis de Dijon" case. The "information model" argues that information rules, while less restrictive compared to mandatory content–related rules, could be equally effective. In the aforementioned case, the ECJ assumed that there is a duty to provide product-related information to the consumer, and furthermore that the consumer has the burden to perceive and process the information. For this purpose, the ECJ constructed the concept of the consumer as an internal market player who is "reasonably well-informed and reasonably well observant and circumspect". This internal market player, argue the authors, shares essential features of the concept of homo economicus. Since the "Cassis de Dijon" case, a more harmonized approach to internal market legislation focusing on information-related rules and moving away from product specifications has occurred. This shift from "content related" rules to "information related" rules assumes that the market players are smart enough to cope with a large diversity of products. However, the authors argue that the internal market player has never had to carry the full burden of information processing for the following reasons: (1) vulnerable market players are protected by specialized regulations such as the Unfair Commercial Practices Directive, the protection of Minors as seen in Article 9 of the Audiovisual Media services Directive, and various rules restricting commercial communication targeted at people suffering from ill-health; (2) regulations recognize the cognitive constraints of market players, such as rules regarding how information must be presented, or regulations placed on information intermediaries; and (3) the explicit or implicit paternalism through regulations aimed at steering the process of decision-making, such as warnings against tobacco products, notices in favour of breastfeeding, formal weighting of required information and defining access to information. Next, the authors discuss how the normative concept of a market player as an addressee of internal market regulations is defined by the requirements of EU primary law. Internal markets, as embodied in the Treaties, aim at enhancing social welfare based on classical free trade theory. This presupposes that individual market players are capable of perceiving and processing transaction-relevant information. The role thereby assigned to the market players conceives the individual as "well-informed, observant and circumspect" as the ECJ has held. The authors go on to argue that the fundamental rights held by each European citizen accounts for the internal market regulations. The

authors discuss, amongst others, the following characteristics of such market regulations: individual weaknesses, cognitive deficits and the paternalistic approach of regulations.

Finally, in her "Economic Principles in Antitrust Law in the Aftermath of the More Economic Approach. General Aspects, Current Issues and Recent Developments", Claudia Seitz focuses on the two different approaches to antitrust law: the traditional form-based approach, and the effects-based approach. Assessment of economic situations require economic analysis, therefore empirical evidence is required in order to understand the market effects which antitrust law must then provide provisions for without endangering a competitive market. An effects-based or more economic approach takes into consideration the vital empirical evidence while a more form-based approach leads to a system that provides more legal certainty and is easier for lawyers to handle. To illustrate a more economic approach, the author uses the example of the assessment of abuses of market power. One of the most important assessment approaches towards a more effect-based approach discussed is the EU Commission DG Competition Discussion Paper from 2005. The objective of this Discussion Paper was to: (1) define a new approach to abusive exclusionary conduct by dominant undertakings of Article 102 of the TFEU, and (2) to confirm a new approach for the enforcement of antitrust provisions of the TFEU in general. These discussions lead to the conclusion that exclusionary conduct, which does not harm consumers, should not be classified as abuse. Next, Seitz discusses objective justifications and efficiencies in view of EU antitrust law compared to US antitrust law. EU antitrust law recognizes three types of defences for exclusionary conduct: the objective necessity defence, the meeting competition defence, and the efficiency defence. The Discussion Paper defines four conditions which must be fulfilled for an efficiency defence: (1) the efficiencies are a result of the conduct concerned, (2) the conduct is indispensable to realize these efficiencies, (3) the consumers benefit from these efficiencies, and (4) competition is not fully eliminated. The burden of proof of these conditions lies with the company. However, it is interesting to note that this is the first time an efficiency defence is recognized in the context of Article 102 of the TFEU. The approach of EU antitrust law in the past was, however, built on so-called *per se* rules. These standards assume that certain types of business arrangements are inherently anti-competitive. The author continues her discussion of the Discussion Paper and the new ways it assesses economic efficiencies, from the change of definition of market dominance, the change of definition of abusive behaviour and the need for a case-by-case assessment. Next, the benefits of a form-based approach in comparison to the effects-based approach are discussed. These include: simplicity, time and cost-effectiveness, and legal certainty and predictability. The benefits of the effects-based approach include case-by-case assessment, flexibility for companies and better consideration of efficiencies. The author concludes by discussing the various conflicting goals, theories, and interests that antitrust law must somehow address. In particular, the goals of society, the conflicting economic theories, conflicting public interest, and the conflicting objectives of antitrust law.

A bon mot from law and economics literature states: law is too important to be left to the lawyers. However, this also applies vice versa: economics is too important to be left to the economists. Lawyers, therefore, should possess themselves of economic methods. As the older generation of lawyers in Europe are often reluctant to do so, hope lies with the younger generation of legal scholars. The observation that progress in science is usually initiated from its edges and brought forward by young scholars, should serve as encouragement. Economic analysis of law, in the right hands, will be a great enrichment for law in European countries. Therefore, this anthology with its 14 chapters from young European legal scholars is an important milestone in establishing an European law and economics culture and tradition.

Lucerne Klaus Mathis
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Part I
Civil Law Versus Common Law

Chapter 1
Never the Twain Shall Meet?

A Critical Perspective on Cultural Limits Between Internal Continental Dogmatism and Consequential US-Style Law and Economics Theory

Kai Purnhagen

Abstract Why could law and economics theory (hereinafter L&E) develop to become the most prominent theory in US legal scholarship, while still playing only a minor role in Europe? As this article is also meant as a gloss, as "a propagandist tracet"[1], I herein make use of my academic freedom to write freely also on controversial issues. If there is a grain of truth in what I am proposing here, it might help to de-mystify L&E theory and classify it to what it to my mind, really is: one very convincing and influential theory, but only one theory out of many that might explain the law. I will argue that it is not only the persuasiveness of the theory that helped to establish the continental divide in legal thought. But that cultural reasons also contributed to a significant extent. Some of them, such as World War II, are external social factors. Other factors, such as the influence of the Olin foundation, resulted from internal factors. As Grechenig and Gelter convincingly explain, at the beginning of the movement in the nineteenth and the early twentieth century the developments were comparable in Europe and the USA. The Nazi regime and World War II then marked a turning point, which resulted in reservations against L&E thinking. Europe responded with a renaissance of classical legal thought (hereinafter CLT), while in the USA, the L&E theory developed further unhindered. This development, however, was not autonomous but influenced by man-made culture on both sides. Only recently, arguments from L&E are able to grasp hold in Europe. Interestingly, this development goes hand in hand with the upcoming of a new generation that has not been influenced by World War II. Furthermore, this generation benefited greatly from incentive mechanisms to grapple with American legal thinking through funding and the legal society likewise.

[1]Henry Simons, cited after Coase, p. 240.

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The fall of the Berlin wall, I will argue, marks a second point in history, which brings L&E arguments to Europe and classical legal thought to the USA. I will close with a call for a specific EU-based idea of L&E, which starts from the outset as a method freed from the ideological struggles that accompanied the introduction of L&E in the USA. It shall live towards the aim of establishing both, a free and social market economy.

1.1 The Argument

While L&E managed to over the last century become the most dominant theory in the USA, Europe has been hesitant to accept such arguments. Although there is movement, national laws in Europe still largely rely on systematical, internal, non-consequential legal thinking.[2] On the continent, systematical thinking revels in principles-based dogmatism, while common law is based on the development of a pragmatic legal system, based on precedents.[3] Since the fall of the Berlin wall and the upcoming of a new generation of lawyers, which were not influenced by the war, L&E arguments are also taking hold in Europe. In the USA, in contrast, CLT is being reintroduced.

Several scholars have researched comprehensively this phenomenon with regard to the time before the fall of the Berlin wall and provided an explanation. While most scholars such as Ugo Mattei and Roberto Pardelosi[4] stress institutional arguments for the divergence, Grechenig and Gelter[5] were, to my knowledge, the first who deliberatively argued for a cultural clash. While they also mark World War II as the beginning of the divide, they mainly explain the development thereafter with different philosophical schools on both sides of the Atlantic.[6] While this is true, I argue that other cultural events, which are more based on policy options, also contributed to this outcome. The second wave, which displayed itself mainly in the reintroduction of L&E arguments in Europe and CLT in the USA, still lacks adequate research. I again argue that cultural influences such as the support of legal education of the post-Berlin wall generation abroad are responsible for this development.

[2] Bengoetxea, pp. 65 et seqq.

[3] v. Caenegem, pp. 44–48.

[4] Mattei and Pardolesi, pp. 265 et seqq.

[5] Grechenig and Gelter, pp. 295 et seqq.

[6] Grechenig and Gelter, pp. 309 et seqq.

1.2 Transatlantic Divergence in Legal Thought and Its Cultural Impact

I will first introduce some terminological clarifications (Sect. 1.2.1), before I map the common transatlantic heritage of L&E ante-World War II (Sect. 1.2.2). I will then provide selected cases as evidence for the divide in legal thought after World War II and their cultural influences (Sect. 1.2.3). Subsequently, I will highlight the development after the fall of the Berlin wall, which likewise triggered the reintroduction of L&E arguments in Europe and Classical Legal Thought in the USA (Sect. 1.3). Finally, I will conclude that intentional cultural impact rather than an intellectual support or denial of convincing ideas contributed to both, the transatlantic divide and the merge in legal thought. I will call for a European reception of L&E-arguments, which takes advantage of the fact that it does not have to deal with the ideological burden that US-style L&E carries. It shall work towards the goal of establishing a highly competitive social market economy. European L&E shall reflect the European culture by incorporating both facets, external and internal analysis of law working toward the goal of achieving a free market competition based on social justice (Sect. 1.4).

1.2.1 Terminological Clarifications

When I use the term "culture", I refer to intentionally man-made occasions in the sense Immanuel Kant developed the term culture[7] in opposition to "natural", given phenomena. I use the term "L&E – argument" mainly to describe consequential[8] or functional[9] legal thinking, which targets at the achievement of efficiency.[10] Efficiency, however, is not necessary limited to the achievement of one specific purpose such as Pareto-efficiency or the decrease of transaction costs.[11] It is moreover, understood more widely to describe the extent to which law is well used for an intended task or purpose, based on deductive analysis and the assumption of rational individual behaviour.[12] CLT describes doctrinal, internal analysis of law, which understands law as a coherent principally gapless whole.

There are two assumptions that I, for the purposes of this essay, take for granted: first, both, the efficiency criterion and the coherency criterion as basis for

[7] Kant, § 83.

[8] Mathis, 'Consequentialism', pp. 3 et seqq.

[9] Micklitz, 'Visible Hand', pp. 3.

[10] See Mathis, 'Normative Principle', pp. 113 et seqq.

[11] See regarding the many schools which use "L&E" as an umbrella term Macneil, pp. 696 et seq.

[12] These facets are what Macneil correctly describes as unifying factors of L&E-theory, see Macneil, p. 697.

analysis are not value-free scientific assumptions, but may in fact (not necessarily intentionally) be used to hide policy choices and ideologies.[13] Second, what matters is not only whether a certain rule meets a specific criterion such as efficiency or coherency but, moreover, who decides on rules and their interpretation.[14] This institutional question is much better fit to tell us about the outcomes of the different values and social goals underlying the respective law and therefore even about the law itself.[15] What matters furthermore is not only what some black letter law stipulates, but which actors apply the law in what way. I will therefore take a closer look at the actors involved with the upbringing and denial of L&E in the USA and Europe.

1.2.2 The Common Transatlantic Heritage of L&E Ante-World War II

CLT and especially non-consequentialist thinking has long been the prevailing view in ante-World War II Europe and at the same time, in English-influenced USA. This was not without exception: in Europe one can trace back thinking about the involvement of economic analysis into law up to the early nineteenth century.[16] With regards to the consequentialist feature, scholars such as Rudolph von Jhering in the nineteenth century have already mourned the non-consequentialist thinking of their colleagues at the time: "The fundamental idea of law as a means to an end consists in the thought that Purpose is the creator of the entire law; that there is no legal rule which does not owe its origin to a purpose, i.e., to a practical motive".[17] According to his theory, law is hence one of the "apparatus which the state employs for realizing its purpose".[18]

Taking von Jhering as an example of the progressive scholarship at this time, we should, however, take care when concluding that such an approach is comparable to what we know as L&E today or may even serve as a "first wave" of L&E thinking.[19]

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[13] See Kennedy, pp. 465–474; v. Jhering, *Scherz und Ernst*, pp. 262 et seq.

[14] See Esser, p. 20: "[T]he legal institute and the codified norm [is] only one category among other factors and materials that influence the decision: logic, principles, legal terms, precedents and other sources of law. All of which influence what is dubbed 'interpretation' and 'subsumtion', whereas the unity of the 'system' in the view of necessary antagonisms of several factors and principles lies not within the corpus iuris, but is created each time through the process of interpretation." (own translation).

[15] Komesar, pp. 4 et seq.

[16] Heath Pearson, *Origins of Law and Economics – The Economists' New Science of Law, 1830–1930*.

[17] v. Jhering, *Law as a Means*, p. 34.

[18] v. Jhering, *Law as a Means*, p. 34.

[19] Mackaay, pp. 69–71.

Although von Jhering advocated for consequentialist thinking, he strongly opposed any idea that society forms the basis for law.[20] "All legal measures [...] have man as their purpose. But social life, in joining mankind into higher groups through the community of permanent purposes, extends thereby the forms of human existence".[21] "It is through the content [of the law, addendum] that we learn the purpose which law serves in society"[22] and not the other way around.

Even in von Jhering's eyes, law was still formal, having its own purposes such as order, predictability, freedom from arbitrariness, legal equality, legal security, and legitimacy.[23] Robert Summers dubbed these "purposes" with unspoken but obvious reference to Max Weber "general rationales for legal formality – values behind the law".[24] In this way, albeit von Jhering's ideas are based on consequentialist thinking, he may still be very much understood as being part of CLT.[25] When taking into account the social environment of their time, it becomes quite obvious that their schools had little to do with what later triggered L&E thinking: scholars such as von Jhering were influenced by legal naturalism, where "national ideals where tied to the social ideals of a society and a nation".[26] Their scholarship – although labelled as *Rechtswissenschaft* – was not so much concerned with the establishment of a science but with regulating common features that could be used as alleged facets of a typically German or, with regards to scholars interested in the making of other European nations at that time, other nations such as the Austrian, French or Dutch nation.[27] CLT aiming at the detection of "values behind the law" by storytelling[28] was, at first sight, a much better fit than consequentialist thinking based on statistical or economic evidence for this purpose.[29]

At the beginning of the twentieth century CLT came under attack in the USA and Europe likewise. Oliver Wendell Holmes in his famous "The Path of the Law" challenged the then prevailing methodological legal thought and introduced

[20] For a similar interpretation see Summers, *Essays*, p. 30.

[21] v. Jhering, *Law as a Means*, p. 345.

[22] v. Jhering, *Law as a Means*, p. 325.

[23] v. Jhering, *Law as a Means*, pp. 267–294.

[24] Summers, *Essays*, p. 30.

[25] See Rob van Gestel and Hans-Wolfgang Micklitz propose the opposite, when they argue that v. Jhering took "a distance from formalism and systematization", see v. Gestel and Micklitz, p. 29.

[26] Micklitz, 'Introduction', p. 19.

[27] Ari Afilalo, Dennis Patterson and Kai Purnhagen, 'Statecraft, the Market State and the Development of European Legal Culture'.

[28] Blaug, p. 126: "Storytelling makes use of the method that historians call colligation, the bundling together of facts, low-level generalizations, high level theories, and value judgements in a coherent narrative, held together by a glue of an implicit set of beliefs and attitudes that the author shares with his readers."

[29] For matters of clarification it shall be noted here that one many use statistical and economic evidence likewise for ideological manipulation, see Ruckelshaus, p. 157–158: "[D]ata can be like the tortured spy. If you torture it long enough it will tell you anything you want to know."

a prediction theory, which puts the possible outcome of judiciary decisions in the centre of analysis.[30] This claim went far beyond von Jhering's ideas, as – according Holmes – law makers should examine conflicting desires, "make a quantitative comparison", and choose that for law which will bring the "greater" satisfaction of desires.[31]

> A sound body of law [. . .] should correspond with the actual feelings and demands of the community, whether right or wrong.[32]

In order to assess the relevant data of society one needed statistics and economists:

> 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.[33]

By doing so, Holmes established what later has become known as the school of "Realism". In Europe, the free-law-movement rejected CLT to the same end as later legal realists did in the USA.[34] The free law school grasped hold at a similar speed as Legal Realism in the USA and was soon widely recognized.[35] Their ideas, mainly attacking von Savigny's methods,[36] largely resembled the ones of legal realism in the USA. However, as their work was still influenced by nationalistic thinking, they were intellectually closer to von Jhering than to Holmes.[37] At least when judging their impact on CLT, we could nonetheless speak of a more or less parallel development in Europe and in the USA. As most of the scholars within the free law school were of Jewish heritage, they lost influence when the Nazi regime took hold in Europe.[38]

A similar school, which later was called early German "Realists"[39], developed out of the academic environment of Edmund Husserl in the early twentieth century. The legal phenomenologists shared the view that law is not "made" by whatever authority, it rather pre-exists in society beyond such law-making exercises and may be "detected" via a phenomenological method.[40] They argued against the rise of positivistic thinking at their time and emphasised that law should be based on

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[30] Holmes, 'Path', p. 457.

[31] Holmes, 'Science', p. 456.

[32] Holmes, *The Common Law*, p. 41.

[33] Holmes, 'Path', p. 469.

[34] Wallace, pp. 399 et seqq.

[35] Grechenig and Gelter, p. 351.

[36] Kantorowicz, pp. 335 et seqq.

[37] Micklitz, 'Introduction', p. 19.

[38] Grechenig and Gelter, pp. 351 et seq.

[39] James Dubois, *Judgment and Sachverhalt: An Introduction to Adolf Reinach's Phenomenological Realism*.

[40] See Kai Purnhagen, 'The Architecture of Post-National European Contract Law: A Question of Institutions?'; Sophie Loidolt, *Einführung in die Rechtsphänomenologie*.

factual existing social relations.[41] However, as a movement of legal scholarship, legal phenomenology never gained a strong hold in Europe. One of the two main protagonists Adolf Reinach died relatively early in World War I. Gerhart Husserl, after the Nazis first expelled him from the University of Kiel and later withdrew his license to teach, immigrated in the USA. Wilhelm Schapp, who in his later writings on historical phenomenology became even more radically realistic, was never embedded in an academic environment. Meanwhile in the USA, Legal Realism could continue to develop. This has been – as Grechenig and Gelter already convincingly explained – the starting point for the transatlantic divide in legal thought.[42]

We find, as some make us believe, a quite different picture in the Scandinavian countries, which have always been sharing a realistic view of the law.[43] This has led some scholars to believe that, due to the semantic heritage of the theory or, as Brian Leiter has put it, "a misfortune and accident of intellectual history",[44] Scandinavian Realism equates or is somehow connected to what Americans perceive as Realism.[45] Scandinavian Realism was developed out of a philosophical background to oppose idealism, while American realism aimed at the detection of Law in Action against black letter analysis.[46] Hence, for the purposes of this essay, we may leave the movement of Scandinavian realism aside.

1.2.3 The Divide in Legal Thought After World War II (First Wave)

The divide deepened after World War II due to cultural reasons. These cultural impacts helped L&E thinking to become the dominant theory in the USA (Sect. "Cultural Influences on L&E in the USA"). To the same extent as culture was responsible for the raise of L&E in the USA, cultural ideas had an impact on the prevailing view on classical legal thought in Europe (Sect. "Cultural Influences on Classical Legal Thought in Europe").

[41] Schapp, 'Sein und Ort', p. 39.

[42] Grechenig and Gelter, pp. 351 et seqq.

[43] Herbert Hart, 'Scandinavian Realism'.

[44] Brian Leiter, 'Legal Realisms, Old and New'.

[45] Alexander, pp. 132 et seqq.

[46] Brian Leiter, 'Legal Realisms, Old and New'.

Cultural Influences on L&E in the USA

American realism established the ground for consequentialist L&E.[47] But how did L&E become the *prevailing* theory in US legal thinking among other schools based on the ideas of legal realism? Realists' thinking has indeed established a ground for many movements in US scholarship, of which L&E is just one. The success of Legal Realism in the USA hence cannot be the only reason for the success of L&E. If not realist thinking, what was it then that put L&E thinking on the map in the USA, while it could not grasp a hold in Europe? Most prominently, the different legal education system and the different role of courts on both sides of the Atlantic are mentioned.[48] While these factors undoubtedly facilitate the transatlantic diverge, they still cannot explain why it was especially L&E-thinking out of all realist schools that became prominent. I will argue that the development of L&E in the USA was influenced by cultural implications.[49] As such implications were missing in Europe, L&E has not been introduced there.

A word of clarification: I do not argue that the cultural ideas presented here are the ONLY means for the rise of L&E in the USA. My argument is therefore no conspiracy theory. However, the factors presented herein certainly influenced this development more than it has been admitted. I also do not argue that the rise of L&E is not due to its intrinsic character of intellectual persuasion. We learn quite the opposite to be true from the debate between Posner and Calabresi. And although I am nonetheless rather critical at many accounts to a large number of theories that have the L&E label attached to it, their philosophical "beauty",[50] persuasiveness and fit to explain and solve legal problems when properly applied have to be recognized.

Among the first figures who formed the intellectual basis for L&E were Ronald Coase, Aaron Director, Richard Posner, Guido Calabresi, and Richard Epstein. Although not all of them were based at the University of Chicago Law School (Yale-graduate Guido Calabresi has never set foot in Chicago law school), this Midwestern school has been providing an intellectual home for the L&E development ever since.[51] Ronald Coase's note that the L&E development "is bound up with the University of Chicago and particularly with the Law School"[52] is certainly true in so far as it has been the main political promoter[53] to an extent up to which US-style

[47] Grechenig and Gelter, p. 348.

[48] Mattei and Pardolesi, pp. 265 et seqq.

[49] See for similar analyses of this claim Régis Lanneau, 'Dogmatics in Comparison to US-American Law and Economics – Dogmatism as Cultural Element of Law in Europe?'; Steven Teles, *The Rise of the Conservative Legal Movement*.

[50] Mathis, *Efficiency*, p. v.

[51] Mathis, *Efficiency*, p. 1.

[52] Coase, p. 240.

[53] Henry Manne: "anything out of Chicago law school at that time was ideological", cited after Teles, p. 99.

L&E is nowadays inextricably connected with the works of Chicago law professor Richard Posner.[54] L&E earned its academic credentials, however, mainly through the works of Guido Calabresi and the reception of Chicago scholarship at Yale Law School.[55] Be it as it may, Chicago at that time was an important intellectual and ideological home to the L&E movement. As many academics know, being an intellectual home does not necessarily mean to also provide the financial means such a home would deserve. Looking back to his years at Chicago law school, Hein Kötz noted with a certain admiration that Richard Posner had been writing his "Economic Analysis of Law" "from morning to night hunkered over an old mechanical type writer, without a secretary, without an 'anteroom', without assistants and without third-party funds".[56]

What inspired the early L&E movement in Chicago moreover was a hostile takeover by accident, as the Chicago law school provided the economist Henry Simons, whose work has not been perceived well at the Chicago faculty of economics, with a half-time appointment to the law school.[57] The relationship between Simons and the Chicago economists department has since then always been a difficult one, defined by reservation on both sides. The triggers for Simon's career were certainly pulled in Chicago law school, who first made him part-time professor, then – after 18 years – granted Simons a tenure position.[58] Although his first appointment was more by accident, he later developed a research plan for the interdisciplinary intellectual future at Chicago. Inspired by his mentor Friedrich Hayek, he aimed for the establishment of an independent and interdisciplinary research institution of political economy in the USA, which should be devoted to Hayek's ideas of libertarian internationale.[59]

These developments resulted in an interaction of lawyers and the economist Simons, which led to the belief that an economist at Chicago law school was indispensable. As Simons died before his project could start to walk, his successor Aaron Director took over and made the centre being, from the viewpoint of marketing L&E, a success. However, although this environment has brought to light many of the intellectually and ideologically most brilliant ideas of our time, the Chicago L&E-people only had some impact, but their ideas had not yet become prominent. It was still one of the many branches of Legal Realism, which lived besides Critical Legal Studies, Legal Sociology and the like. In fact, despite Holmes' early works and the L&E movement, reservation against consequentialist conceptions of the law prevailed in the 60ies and 70ies in the USA.[60] The events that made L&E become dominant in the USA combined two factors. The first factor

[54] Macneil, pp. 697 et seq.; Teles, p. 96; Mathis, *Efficiency*, p. 1.

[55] Teles, p. 99.

[56] Kötz, p. 100 (own translation).

[57] Coase, p. 243.

[58] Coase, p. 243.

[59] Teles, p. 93, with further references.

[60] Tamanaha, p. 101.; Posner, p. 761.

is widely known and accepted today: the reception of Posner's "Economic Analysis of Law" in Yale and the subsequent debate between Calabresi and Posner. As to the intellectual richness of this debate about the importance of efficiency as a value, the publication of Posner's book is regularly perceived as the trigger of L&E becoming the leading theory in the USA.[61]

When looking back, a movement often refers to the events in history that shed a better light on the events in order to make history work for achieving the goals of the present and future. In this case, the L&E scholarship as an intellectual movement better requires intellectual heroes such as Simon, Posner, Aaron and Calabresi who brought L&E up simply by the intellectually persuasiveness of their concepts. The truth is often not that easy to find. And as intellectually brilliant and original people are most of the times not the best salesmen, there is often someone involved who does the marketing job.[62] Max Weber had Paul Siebeck, Friedrich Engels had Karl Marx, and the law and economics movement had Henry Manne:

> Even accepting this market-based measure of influence of Demsetz, Calabresi, and Posner, I believe that it is undeniable that Manne has had the greatest intellectual influence over the field of law and economics. However helpful Harold Demsetz's articles, however riveting to many of us the Posner-Calabresi debate, those who paid careful attention to either could not have numbered more than 100. In contrast, Manne introduced, popularized, and extended law and economics to thousands. Manne achieved this influence in three basic ways: first, his instructional programs of law for economists and economics for lawyers; second, his programs on various law and economics topics for judges; third, and to my mind just as important, the academic conferences that he organized, many supported by the Liberty Fund. The instructional programs for economists, lawyers, and judges will be addressed separately. I would like to add a few words about his academic conferences, the importance of which – in market terms – has not been sufficiently appreciated.[63]

In other words: L&E has only been successful in the USA after culture kicked in. The Chicago and Yale graduate Henry Manne, after spending some years working in corporate law at George Washington University,[64] started a career as a Professor at the political science department of the University of Rochester. Although his initial plans to create a new law school at Rochester that was solely devoted to L&E failed, he did manage to establish influential lawyer's seminars on L&E.[65] The attendees of these seminars such as Steve Eagle, Michael Graetz, Warren Schwartz, and Michael Trebilcock have later become well-known L&E scholars. Manne continued his approach after leaving to the University of Miami, where he founded the Law and Economics Center (hereinafter Center).[66] The Center received funding from the Olin foundation, whose donor John M. Olin had the explicit goal to introduce free-

[61] Mackaay, pp. 66–67.

[62] Priest, p. 325: "Pure originality, however, is a peculiar standard for intellectual influence. Originality does not correspond to influence; most commonly, the relationship might be reversed."

[63] Priest, p. 325.

[64] See Carney, pp. 215 et seqq.

[65] Rubin, p. 333; Teles, pp. 105 et seq.

[66] Teles, p. 108.

market thinking into US American law schools.[67] The L&E movement together with the ambitious Manne formed the framework for the development of Olin's ideas.[68] The Center intentionally brought PhD's in economics as Olin fellows to Miami and equipped them with full law-degrees.[69] After that, they were ready for the market to become law professors and teach law and economics in traditional law schools. In addition, Manne raised funding from other institutions to organize conferences and build up a network that became a powerful source of inspiration in legal academia.[70] Furthermore, he provided free and luxurious courses for Federal judges in law and economics.[71] After some dispute with the University of Miami, Manne moved his center with the support of Olin to Emory University.[72] After minor struggles, the ambitious Manne fell out with the University's President Laney over a dispute regarding the financing of a building for the Center.

Manne's trainings yielded fruits especially at the University of Virginia and University of Southern California.[73] As graduates from the University of Miami and Emory could only qualify for lower "first tier" or "second tier" schools, Manne's programme lacked in prestige to be officially recognized by the elite law schools. His struggle with Laney was therefore a welcome opportunity to reconcile the Olin foundation's investments. After this struggle in the 1980s, Olin capped Manne's support and invested in L&E programmes in the elite law schools.[74] They invested mainly in the Universities of Chicago and Yale, probably because the success of these investments were more likely as L&E has intellectually already been present in these schools.[75]

At the same time, Harvard University was in "danger" of being taken over by the Critical Legal Scholars movement (hereinafter CLS)[76] from Wisconsin-Madison.[77] The Olin foundation interfered in order to counterbalance this development. Indeed, the Olin foundation invested in a number of courses and professors in law and economics.[78] However, in Harvard, they have not been as successful as they were in Chicago and Yale. In Harvard, CLS scholars such as Duncan Kennedy furthermore lived side-by-side with L&E scholars, enriching the debate on legal scholarship, while in Yale CLS scholars such as David Trubek had to give room for classical L&E

[67] Miller, p. 66.

[68] Teles, p. 110.

[69] Rubin, p. 333.

[70] Rubin, p. 333.

[71] See Priest, p. 325, who notes with subtle irony in fn. 12: "That these resorts were uniformly near fancy golf courses was coincidence."

[72] Teles, p. 142.

[73] Teles, p. 118.

[74] Teles, pp. 186 et seq.

[75] Teles, p. 189.

[76] Teles, p. 192.

[77] Russel, p. 3.

[78] Teles, pp. 193–199.

scholars. With Yale, Harvard and Chicago as a backup, the Olin foundation widened its investments successfully to Penn, Stanford, Berkeley, Virginia, Columbia, Duke, Georgetown, Toronto, Cornell and Michigan.[79] By the year of 2000, no one could deny that L&E had become the most dominant legal school in US scholarship. When a theory becomes dominant, herd behaviour kicks in and the majority of scholars, for several mostly rational reasons, follow the major trend.[80] Nowadays, scholars in the USA have a hard time being taken seriously without a profound background in L&E.

The success of L&E in the USA hence resulted mainly from two factors: the intellectual persuasion coupled with strong monetary support and entrepreneurship by the Olin foundation and Henry Manne.

Cultural Influences on Classical Legal Thought in Europe

Unlike the USA, post-World-War-II-Europe has been busy digesting the cruelty of the Nazi regime. Especially Europe's biggest country and host of Nazism Germany was eager to show to the world that it had exorcised the spirits from the past. In order to do so, law played an important part. When evaluating the past, there was a strong belief in Europe that law had failed because of a lack of undisputable legal values, which were enforceable in strong courts. Consequentialist thinking that leads to economic efficiency requires some readiness for moral relativism. Seen through this lens, L&E just did not provide the right approach for a legal system that should primarily restore Europe on a basis of unalienable, enforceable values and rights. At least in Western European nation states, constitutions were drawn which protected values that were not to be subject to any kind of relativism. Especially in Germany, constitutional law was meant to provide a means to achieve some self-confidence by remembering the basic and unalienable values that the German nation shared so many years before the Nazis.

> For years Germans had lived under a regime that simultaneously enshrined the law and suspended it. Now, visions of the past and hopes for the future were so intricately associated with judicial structures that even private citizens from Munich, Stuttgart and Hamburg flooded the new authorities with their draft constitutions and reflections on Germany's constitutional history.[81]

Consequentialist thinking that subordinated law under the goal of a, from a classical legal point of view, somewhat vague term of efficiency was indeed out of place when we contrast these ideas to a constitution, which stipulates the "dignity of human being" as its main principle. In addition, the US-American influence on the basic rights Charta of the German Grundgesetz has been underestimated until today. Governeur Clay, James K. Pollock and Carl Joachim Friedrich were wise enough

[79] See Teles, p. 200, with further reference.

[80] See v. Gestel and Micklitz, p. 37.

[81] Greenberg, p. 443.

to hide their influence on the Herrenchiemsee convent.[82] However, the USA – for obvious reasons – had a strong interest in a German constitution based on basic rights and a strong court system. USA's interest did not root in pure altruism. They required a strong European constitutional society as a block against the communist states in the East.[83] Individual human rights, enforceable via a strong constitutional court, which enables predictability and coherence of the legal system seemed to be best fit for this purpose.

While this is true for European nation-states, the post-war movement that later led to the foundation of first the European Economic Area, then the European Communities and now the European Union has walked a different road. In this newly created supranational regime, classical free-trade theory following Adam Smith and David Ricardo has built the basis for this supranational law right from the beginning.[84] As supranational law necessarily requires some adhesive that is not national, it was trade that was identified to work towards this end. A whole new and autonomous legal culture was to be developed that aimed at establishing first a common market, later an internal market through economic integration.[85] As politics did not succeed as peace-building entities after World War II, it should be free trade that brings the nations of Europe together. Law was assigned especially the task to enforce such economic integration by providing incentives for individuals to foster cross-border trade.[86] Unlike in the post-World-War II laws of the nation-states, economic theory hence has formed the foundations of supranational EU law right from the beginning.[87]

However, even in the post-war period a small L&E-movement began to grow. Central to the movement were people like Ernst-Joachim Mestmäcker and Hein Kötz, who had come in contact with L&E thinking during their stays in the USA.[88] The situation was comparable to the early development of L&E at Yale. Although both, Kötz and Mestmäcker were undisputedly intellectually bright people who later became directors of the Max-Planck Institute for Private Law in Hamburg, there has been no institutional back-up for L&E-scholarship that could be comparable to the Olin foundation. Even legal phenomenology developed less prestigiously. Wilhelm Schapp's son Jan, after becoming professor for legal philosophy in Giessen,

[82] See Friedrich, 'Evolution'.

[83] See the notes of Friedrich, 'Evolution', pp. 197–210, who characterized the difference between constitutional and sovereign dictatorships as the main difference between the American and the Soviet occupations of Germany.

[84] See Jens-U. Franck and Kai Purnhagen, 'Homo Economicus, Behavioural Science, and Regulation: On the Concept of Man in Internal Market Regulation and its Normative Basis'.

[85] Ari Afilalo, Dennis Patterson and Kai Purnhagen, 'Statecraft, the Market State and the Development of European Legal Culture'.

[86] Craig, p. 14.

[87] See on the difference between the nation states' law that strived for protection of sovereignty and the conflicting pro-integrationist interpretation of EU law Ari Afilalo, Dennis Patterson and Kai Purnhagen, 'Statecraft, the Market State and the Development of European Legal Culture'.

[88] See Kötz, p. 94; Ernst-Joachim Mestmäcker, *A Legal Theory With Law*.

continued to promote legal phenomenology among academia with little success. Gerhart Husserl, after returning from the USA, has never taken a strong effort to re-enter legal academia. His academic credentials were, except among a small group of civil lawyers and philosophers, little. Hence, he never received funding or any other support. His academic sons did not receive tenure and therefore also not the means they would enquire to continue the academic work.

Some thoughts that had guided L&E in the USA suddenly reappeared in the ordoliberal school, which was no surprise as both schools perceive Friedrich v. Hayek as their academic mentor.[89] The ordoliberal school received funding from the Walter Eucken Institut since 1954. However, neither proposed the ordoliberals a theory fully comparable to the L&E-movement in the USA, nor was the Walter Eucken Institut as financially powerful as the Olin foundation. Especially with regards to consequentialism, the main feature of L&E, ordoliberals were quite sceptical. Hence, Chicago-like liberal thinkers, which would have been a potential recruiting ground for L&E in Europe, were captured to a great extent within the ordoliberal school, which upheld strong constitutional ideas besides a free market economy. These reasons surely contributed to the fact that L&E-arguments have had a minor influence on Europe at that time.

1.3 The Coming Closer After the Fall of the Berlin Wall (Second Wave)

Like so many other fields of society, the time of the fall of the Berlin wall marks the beginning of a new era[90] also in transatlantic legal thought in the USA and Europe. In the USA, Legal Realism and therefore also L&E consequentialist thinking was challenged by the "new formalism" movement.[91] Justice Scalia,[92] Frederick Schauer,[93] Ernest Weinrib,[94] Robert Summers[95] – just to mention a few – have each from their own perspective enthusiastically advocated for an analysis of the law based on its legal text, historical idea, and coherence. Among these protagonists Justice Scalia may be the most radical one:

> Of all the criticisms leveled against textualism, the most mindless is that it is "formalistic". The answer to that is, *of course it is formalistic!* The rule of law is *about* form. [. . .] Long live formalism. It is what makes a government of laws and not of men.[96]

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[89] See for a reading on the ordoliberal school Megay, pp. 422 et seqq.

[90] See Patterson and Afilalo, pp. 3, 29.

[91] Thomas Grey, 'The New Formalism'.

[92] Scalia, p. 25.

[93] Schauer, 'Formalism', pp. 509 et seqq, esp. p. 548; Frederik Schauer, *Playing*.

[94] Weinrib, pp. 21 et seq.

[95] Summers, 'Formal', pp. 1165 et seqq.

[96] Scalia, p. 25.

While formalism in the USA is increasing and thereby challenges L&E thinking, formalism decreases in Europe and makes room for more L&E consideration.[97] Schools that devote the intellectual connection to American Realism and most of the time also to L&E suddenly appear all over Europe: In Germany,[98] Italy,[99] Switzerland,[100] Denmark,[101] the Netherlands,[102] just to mention a few, research groups and teaching programmes in L&E or American Legal Realism were established. What has made this turn possible in Europe? To my mind, there are two reasons: the one which is exclusively European is the dying off of the post-war generation. In addition, financial and institutional support that backed up the intellectual presence of L&E in Europe was increased. A general trend towards financing an academic year in the USA paved the way for the rise of L&E theory also in Europe. The Olin foundation, when it was still in its operating modus, opened its fellow programs to also finance a basic training in L&E for European scholars. Several University exchange programs have been established such as between the Universities of Giessen and Wisconsin-Madison, the Universities of Hamburg and Berkeley, the European University Institute in Florence and a number of US law schools and alike. Especially German law firms – who act to a great extent on the US American market – required associates to receive at least a basic training of American legal thinking in their education. The doctrinal German-like education coupled with American consequentialist and sociological legal thinking seemed to be a good match for being ready for the law market. They therefore prefer to hire German lawyers with an additional LL.M.-degree from the USA. This development has also resulted in the provision of the big "cash cow" LL.M.-programmes for foreign lawyers at most elite law school in the USA, which has nothing or only little in common with the original aim of the LL.M. to prepare for academic work.[103] Be it as it may, for these reasons, a whole generation of the best-trained lawyers that did not have any need of reappraising the past were sent to the USA to get to know Legal Realism and L&E thinking. This generation is now either at the point directly before entering their profession or have just become Professors, associates and partners in leading law firms and Universities. Each of these scholars and practitioners introduced some element of Legal Realism and L&E to European legal thinking, may it be its rejection or approval. Edward Elgar's Encyclopedia of Law & Economics provides an illuminating overview on the L&E development in the

[97] To some, this has already yielded the need for a counter-development; see v. Gestel and Micklitz, p. 25.

[98] See e.g. the Institute for Law and Economics in Hamburg, <http://www.ile-hamburg.de/>

[99] Riccardo Guastini, 'Rule-Sceptism Restated'.

[100] <http://www.unisg.ch/de/Studium/Master/RechtswissenschaftMitWirtschaftswissenschaften>

[101] <http://jura.ku.dk/ilecma/>

[102] <http://www.acle.nl/>

[103] A fortunate exception are e.g. Yale and Wisconsin, who still pursue a LL.M. training by research and respective close intensive supervision by the law faculty and in Wisconsin even under involvement in the faculty with a view to promote the education of academics.

second-wave-generation that was in the USA.[104] Most of the prominent members in each country have either been John M. Olin fellows or got into contact with L&E during their stay abroad financed through the various possibilities of third-party funding for this purpose. Interestingly, most of which combine L&E-arguments with classical European internal analysis in their scholarship. As such, there is indeed a coincidence between the rise of funding programmes and the rise of L&E scholarship in Europe.

1.4 Conclusion

While on both sides of the Atlantic L&E theory has had great intellectual promoters, it was the granting or the lack of financial and institutional support that contributed a great deal to the divide in legal thought. Cultural impact in form of intentional financing and strategic support of special interest groups, however, has helped L&E thinking to become prominent in the USA and Europe alike. What Europe still lacks is an entrepreneurial figure comparable to Henry Manne to introduce consequentialist thinking. But maybe Europe also works differently than the USA, as European proponents did not start to simply copy and paste US-style L&E which has traditionally been ideologically biased by the promotion of liberal free-trade theory and rejection of critical and internal scholarship involving issues of social justice. Although US legal scholarship nowadays also aims at combining liberal and social ideas in L&E thinking,[105] European L&E scholars never stopped involving distributive elements in their law and legal scholarship. With few exemptions, Europeans – in knowledge of the ideological debates that led to the dichotomy between critical legal studies and L&E – have never taken the alleged universality and monopoly with colonising tendency of the L&E movement too seriously. When US-style L&E came to Europe, Europeans started from the outset to incorporate Europe's dogmatic, internal and social heritage with L&E arguments,[106] understanding it as an addition rather than a replacement of their analytical toolkit. To rely on a well-known metaphor: in European legal scholarship stamps are still collected first, and then they get analysed by economic, sociological or simply dogmatic theory. What *Rechtswissenschaft* then needs to find out is whether, under recourse to the theory, these stamps are needed and are in the right order.[107] An example

[104] Boudewijn Bouckaert and Gerrit De Geest, *Encyclopedia of Law & Economics*.

[105] See e.g. Cass Sunstein, *Free Markets and Social Justice*; id., 'Humanizing', pp. 3 et seqq.

[106] See for the need to involve internal and external analysis of law in European scholarship Hesselink, pp. 20 et seqq.; For the need to combine social justice with free market economy in Europe see Kai Purnhagen, 'The Architecture of Post-National European Contract Law: A Question of Institutions?'.

[107] Ackermann, p. 11 (stipulates that legal science can only be conducted by combining political and systematical arguments); In Kai Purnhagen, 'The Architecture of Post-National European Contract

of such a typical European understanding of "law and…"-approaches is Armin v Bogdandy's claim that "[t]he project of critical legal scholarship can be pursued with doctrinal research".[108] To this end, a European-style L&E must live up to the idea which has been proven by so many years of battles for the enforcement of peace via EU law: the establishment of "a highly competitive social market economy" (Art. 3 [3], S. 2 TEU).

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[108] v. Bogdandy, p. 16.

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Chapter 2
To What Extent Is the Opposition Between Civil Law and Common Law Relevant for Law and Economics?

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Abstract The distinction between common law and civil law has been used in the law and economic literature at epistemological, methodological and prescriptive levels. The present article will focus on the epistemological level. Is this divide relevant for assessing the relative value of law and economics in a legal system? It will be shown that this divide is largely irrelevant but that some characteristics of legal systems (instrumentality of law, autonomy of legal reasoning and freedom of judges) are relevant. This article will also advocate to distinguish between functions of law and economics and between agents involved in order to gain a better understanding of the role of law and economics in a legal system.

2.1 Introduction

The opposition between civil law and common law systems is well known by the legal academia. Indeed, it is mandatory in any introduction to comparative law and it is often believed that most legal systems follow one or the other of these legal traditions apart from exotic systems such as those found in Japan or China, and atypical ones like Quebec's, Israel's or Louisiana's. This opposition is of course more relevant regarding "private" law than, for example, constitutional law.[1]

This does not mean that a clear-cut definition of either exists (or is possible, since it has been created; or even that there is no debate) except by stipulating a precise definition which is, of course, schematic at an empirical level. In general –

[1] Marie Claire Ponthoreau, *Droit(s) Constitutionnel(s) Comparé(s)*.

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and to keep the flavour of a "real" opposition – the common law is defined as "large body of rules founded on unwritten customary law evolved and developed throughout the centuries"[2] whereas the civil law is characterized by "codification" and "systematization". Some precisions will be added in the second section but this crude distinction is sufficient at this point.

This opposition between legal traditions has been – and is still – used in the law and economics' literature. Three different levels can be identified.

First, at an epistemological level, this distinction has been implemented – among others (such as ideological and political climate,[3] path dependence in legal analysis,[4] the limited role, in Europe, of judge made law,[5] the under-theorization of the common law,[6] etc.) – to explain the difference between the U.S. and Europe regarding the reception of law and economics.[7] Since the U.S. belongs to the common law tradition and Europe to the civil law tradition (except UK and Ireland), legal traditions could be a plausible reason. For example, Mattei argues:

> Because the common law was the legal framework in which most law and economics contributions were developed, anyone interested in discussing the chances of success of this approach in Europe finds himself or herself in need of checking the differences between common law and civil law that may be relevant to his or her problem.[8]

Recognizing that the legal side of law and economics is relevant for the use of this kind of analysis is significant and too often disregarded; however, the relevance of a purely legal distinction was not questioned enough.

Once it has been recognized that "[t]he law and economics movement is genuinely international, and has as much relevance to civil law and developing countries as it does to the Anglo-American common law countries"[9] or that "efficiency, as a way of reasoning about law is no longer limited to the common law world and is diffused among civil law countries as well",[10] it is possible to inquire about the differences in each legal tradition at a methodological level. For example, are the questions raised by a scholar, who belongs to a civil law system, the same as those raised by her counterpart in a common law system? Is there a civil law "style" in

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[2] De Cruz, p. 36.

[3] Jamin, p. 280.

[4] Schäfer, pp. 194–97.

[5] Mattei and Pardolesi, pp. 267–69.

[6] Aristides Hatzis, *The Anti-Theoretic Nature of Civil Law Contract Scholarship and the Need for an Economic Theory*; Garoupa and Ulen, p. 1588.

[7] Wolfgang Weigel, 'Prospects for Law and Economics in Civil Law countries: Austria'; Christian Kirchner, 'The Difficult Reception of Law and Economics in Germany'; for data concerning the reception of law and economics in Europe, see for example Oren Gazal-Ayal, 'Economic Analysis of "Law and Economics"'; contra Ben Depoorter and Jef Demot, 'The Cross-Atlantic Law and Economics Divide: A Dissent'.

[8] Mattei, p. 77; this divide is also used by Dau-Schmitt and Brun, pp. 613–14, 617 and 619.

[9] Posner, 'Law and Economics', p. 67.

[10] Mattei, p. 17.

law and economics' studies? Is the same "type" of scholars interested in law and economics? Except for few articles, this dimension has not produced a reaction from scholars either in article or discussion.

Posner mentioned a "distinctive 'civilian' law and economics movement that focuses on rule of law issues"[11] without trying to suggest any reason for this "fact". Data collected by Gazal-Ayal can be used to investigate the "type" of scholars interested in law and economics but do not reveal essential differences in civil law and common law systems.[12] Few books emphasize the civil law system in their approach without explaining precisely the specificities of civil law systems for the use of law and economics.[13]

More recently a prescriptive use has also been made which states that common law systems are more efficient (i.e. better for the economic growth) than civil law systems. This thesis is known as the legal origins thesis.[14] Even though the concept of legal origins has been extended to extra-legal parameters (such as human capital or the beliefs of the respective participants), it still relied on a common law civil law divide. However, this opposition has been redefined for their purpose by the inclusion of economic parameters:

> Common law stands for the strategy of social control that seeks to support private market outcomes, whereas civil law seeks to replace such outcomes with state-desired allocations.[15]

This thesis has created a vast amount of literature and numerous criticisms. For our purpose, it has been advanced that their understanding of the divide is often crude and that their assignment of a legal system to one or the other legal tradition is thus often faulty.[16] Moreover, they did not take into account the evolution of comparative law regarding this divide.[17]

My objective in this article is neither to enter directly into the debate over a normative use of this opposition,[18] nor to identify specificities in each legal tradition (I believe that this cannot be answered adequately for reasons that will become clear in the article). My purpose is more modest and lies at an epistemological level. To what extent is a difference in the legal architecture – a formal legal aspect –

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[11] Posner, 'Law and Economics', p. 67.

[12] Gazal-Ayal, pp. 806–809.

[13] Hans-Bernd Schäfer and Claus Ott, *The Economic Analysis of Civil Law*; Bruno Deffains and Thierry Kirat, *Law and Economics in Civil Law Countries*.

[14] Raphael La Porta, Florencio Lopez de Silanes, Andrei Shleifer and Robert Vishny, 'Legal Determinants of External Finance' and 'Law and Finance'; see also Raphael La Porta, Florenico Lopez de Silanes and Andrei Shleifer, 'Economic Consequences of Legal Origins'.

[15] La Porta, Lopez de Silanes and Shleifer, p. 286.

[16] Siems, pp. 65–70.

[17] *Infra* (Sect. 2.2.2) and Rudolf Schlesinger, 'The Past and Future of Comparative Law'; Michaels, pp. 780–783; contra Pierre Legrand and Geoffrey Samuel, *Introduction au Common Law*; Pierre Legrand, *Droit Comparé*.

[18] For some critics, see Ralph Michaels, 'Comparative Law by Numbers? Legal Origins Thesis, Doing Business Reports, and the Silence of Traditional Comparative Law'.

relevant for law and economics? Can this distinction portray a disparity in the use or acceptance of law and economics? Is this distinction only a proxy for more profound legal characteristics that could explain the reception of law and economics in a particular system?

Before presenting my two theses, a few distinctions have to be made concerning the notion of "use" of law and economics.

The first distinction regards the "which". I will not use the classical descriptive, predictive, prescriptive distinction. This distinction has been identified for economics, that is for a purpose that is completely different from an inquiry into the relevance of law and economics for the legal sphere; it seems at best inadequate. Indeed description in law and economics is in general an abductive approach (assuming the economic framework, how is it possible to explain one particular legal phenomenon? And then it is followed by a "judgment" about the "proposed" hypothesis[19]), prediction is simply an analytical truth that derives logically ceteris paribus from a model[20] (empirical testing helps to accept one hypothesis but cannot be conclusive if we abide by Popperian or Lakatosian criteria) and prescription misses the link between the model and reality so that its use is merely rhetorical.[21] I will use instead an abductive, heuristic and rhetorical divide – a legal distinction to characterize the use of law and economics in the legal sphere. I hope that at the end of this article the relevance of this new distinction for this subject matter will appear self-evident. The abductive/hermeneutic function uses law and economics to inquire into legal phenomena; law and economics is seen as a tool-box to gain a "better understanding" about the world. It helps to ask questions and to envisage consequences of legal rules and institutions. The heuristic function is used in order to make a decision; law and economics does not "decide" but is used to help make a decision. It is more than the abductive function since it relies more on law and economics' results. The rhetorical function understands law and economics as a tool of justification. The problem is not to be "scientific" but to use the "prestige" of science to influence decision makers in the legal arena (it is a doctrinal use of law and economics). Of course, these three functions are linked: heuristic and rhetorical functions, for example, imply the abductive/hermeneutic function (but the reverse is not true).

The second distinction regards the "who". Law and economics can be exploited by different kind of agents: legislators, judges, lawyers, scholars (both as critics and teachers). When the question of the relevance of law and economics is asked, this distinction is important. Indeed, there is a flaw if we focus our attention only on judges' behaviour even if "the most important focus of law and economics, on both

[19]This remark is made for example by Jon Elster, *Le Désintéressement: Traité Critique de l'Homme Economique tome 1*. See also Ogus, pp. 384–385: "For this reason it may be preferable to refer to this type of analysis [positive law and economics] as 'interpretive' or 'explanatory'."

[20]Indeed, a model is mostly a mathematical structure, that is a logical one that cannot say anything – by itself – about the world. It only gives analytical truths.

[21]For more developments on this new distinction and the inadequacy of the old one, see Régis Lanneau, *Les Fondements Epistémologiques du Mouvement Law & Economics*.

positive and normative grounds, is the judge's behavior" since law and economics is also a "scholarly paradigm".[22]

With the help of these distinctions, it will be possible to prove that:

1. Legal traditions are irrelevant for the use of law and economics. Clearly, the abductive/hermeneutic function does not depend on them. Regarding the hermeneutic and the rhetorical function, legal traditions impact the "who": These functions are present but are not applied by the same agents. Moreover, the focus on legal tradition cannot explain differences inside one legal tradition. For example, how can one explain that Australia, Ireland or New Zealand have not been influenced as much by law and economics as the U.S.? How can one explain the differences inside civil law countries (its relative success in the Netherlands and its relative failure in the French legal academia – principally because of the introduction of a constitutional obligation of impact assessment in April 2009[23])?
2. The question of the impact of legal tradition on the "relevance" of law and economics leads to the identification of three legal parameters that are relevant in order to assess the perceived value of law and economics in a particular legal system: the perceived instrumentalism, the perceived autonomy of legal reasoning and the perceived relative freedom of judges. That is, the closer the perception of a legal system is to the implicit conceptualization of law endorsed by scholars in law and economics, the more the law and economics approach is judged favourably. Indeed, when inquiring into a specific legal tradition, scholars in law and economics are focusing not only on the legal tradition itself but also on some of its perceived characteristics.

Before developing these two theses, one question might also be raised. Because law and economics adopts economic lenses to inquire into legal phenomena, are legal categories or distinctions adapted to these lenses or should law and economics develop some new categories adapted to its problem(s)? This question is linked to the limits of interdisciplinary works, which have not sufficiently been considered in literature of law and economics even though they are fundamental.

2.2 The Relative Irrelevance of Legal Traditions for Assessing the Value of Law and Economics

As Schanze observed:

> If this factor [the difference between judge-made common law and codified civil law] had been of high significance, we would have seen a quick and effective reception in England and Scotland and, for example, a slow reception in Germany.[24]

[22] Mattei, p. 88; see also p. 78.

[23] LO 2009–403.

[24] Schanze, p. 103.

This, of course, was not the case. This "fact" alone, and asymmetries inside one or the other legal tradition regarding the reception of law and economics, could prove the relative irrelevance of legal traditions in assessing the reception and the value of law and economics.

In this section, my point is to demonstrate this irrelevance at an epistemological level. There is no impediment to the reception of law and economics in civil law countries even if a very crude conceptualization of legal traditions is adopted (Sect. 2.2.1); adopting a more modest view (Sect. 2.2.2) helps to explain that only agents are changing but the three functions of law and economics can be used. Legal traditions are indeed a legal distinction that cannot fit with distinctions between legal systems that are relevant from the law and economics' approach. However, this inquiry will be of some help in developing the framework in the third section (since, at least it justifies a new framework); and is relevant to gain a better understanding of what law and economics is doing and what is at stake.

2.2.1 Law and Economics in a Crude Conceptualization of Legal Traditions

Following traditional comparative law, the key difference between common law and civil law lies in codification and in the role of judges.[25]

The civil law tradition is the oldest, the most influential and the most widely distributed around the world.[26] Civil law systems are rooted in the roman *ius civile* and in the rediscovery of the *corpus iuris civilis* in the twelfth century by medieval scholars in continental Europe. Legal definitions and classifications from Gaius and Justinian had a tremendous influence on how to reason using the law and promote legal reasoning attached to "legal categories". Roman law also advances a reliance upon writings that were supposed to promote unity, coherence, rationality and certainty in the legal system.[27] Modern legal codes materialized this tradition. These codes, even if inspired by customary law, are a "rational" product of the State (and State in continental Europe appeared through the affirmation of its monopoly in the creation of law) and law tends to be viewed as "the expression of the general will" (art 6 Declaration of the Rights of Man and of the Citizen).

Mahoney noted:

> Quite apart from the substance of legal rules, there is a sharp difference between the ideologies underlying common and civil law, with the latter notably more comfortable with the centralized and activist government.[28]

[25] Mattei, p. 78.

[26] La Porta, Lopez de Silanes and Shleifer, p. 289.

[27] For a short historical review, see Ponthoreau, pp. 130 et seq.

[28] Mahoney, p. 505.

In this system, the judges are supposed to be a "mere interpreter of law": they have to implement solutions provided by enacted law without "choosing" the content of law which is a "given". If a problem appears, they must refer to the intention of the legislator. They are supposed to be entirely limited by legal codes; their role is reduced to that of a mere "technician". To quote Montesquieu:

> The national judges are no more than the mouth that pronounces the words of the law, mere passive beings, incapable of moderating either its force or rigour.[29]

Judges have to apply a Beccarian methodology in their reasoning:

> The major should be the general law; the minor, the conformity of the action, or its opposition to the laws; the conclusion, liberty, or punishment. If the judge be obliged by the imperfection of the laws, or chooses to make any other or more syllogisms than this, it will be an introduction to uncertainty.[30]

Beccaria drew a clear opposition in task between judges and legislators. The former has "no right to interpret"[31]; the latter is the sole master of legal contents (he chooses the law). Of course, this idealistic conceptualization should be taken as an ideal type and not as a description of how the law is working in a civil law system. It represents a crude conceptualization of this legal tradition.

By contrast, "[t]he common law is formed by appellate judges who establish precedents by solving specific legal disputes".[32] It is uncodified; it is not founded on a rational compilation of legal rules. Holmes summarized: "The life of the law has not been logic: it has been experience".[33] This tradition emerges out of the history of England and especially with the evolving powers held by the King. The story began with the Norman Conquest in 1066. It led to the creation of royal courts and the system of *writs* (royal orders that dealt with specific "wrongs"; for example, the writ of Habeas Corpus). In the fourteenth century, courts of equity emerged; they did not replace courts of law, they coexisted until the mid-nineteenth century (until the writ system was abolished). These courts were allowed to judge according to principles of equity. Their aim was to achieve a "just" outcome, which rests on "the idea of an immanent justice".[34] Of course, statutory law exists in common law countries, however, their aim is to complete or rectify the common law; they did not "form" the majority of common law rules:

> Historically, common law statutory canons were developed originally for "special statutes", in other words, statutes passed by the legislature to cope with specific urgent problems of the day, and these statutory maxims were, therefore, limited to specific problems.[35]

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[29] Montesquieu, book 11, chapter "Some Thoughts on Economic Reasoning in Appellate Courts and Legal Scholarship".

[30] Beccaria, chapter "Homo Economicus Versus Homo Iuridicus".

[31] Ibidem.

[32] La Porta, Lopez de Silanes and Shleifer, p. 288.

[33] Holmes, *Common Law*, p. 1.

[34] Legrand and Samuel, p. 18.

[35] De Cruz, p. 266.

To cope with a profound uncertainty, the common law is largely based on precedents. If a "new" case arrives in front of a judge, she has the power to determine the precedent (jurisdiction hierarchy must be taken into account). Moreover, according to Mahoney,

> English common law developed because landed aristocrats and merchants wanted a system of law that would provide strong protections for property and contract rights, and limit the crown's ability to interfere in markets.[36]

In this system, judges "are concerned with finding the applicable rule within the body of law made up of legal precedents"[37]; judges take part in the creation of law. Judges and legislators are both decision makers; they "shape" the law (the former more than the later). The law is then supposed to evolve more "smoothly" (which is a problem when circumstances require speedier amendment of the law) and is more related to the will of the parties.

If these models are taken in this extremely crude conceptualization, law and economics is still relevant. However, each type of agent is not concerned in the same way. Concerning judges, Mattei notes:

> If the traditional picture of the gap is correct, in a common law system one may trust a judge to be a decision maker who is always concerned with the policy impact of his decisions, while in a civil law system one may simply not make such an assumption.[38]

It is then clear that heuristic and rhetorical functions of law and economics can be manipulated by common law judges but not by civil law judges.

Indeed, if civil law judges are applying law like mathematicians are resolving classical mathematical problems (with only one technical solution), there is no need to apply economic reasoning in order to "find" a solution to one dispute and, *a fortiori*, to justify its solution:

> In systems belonging to the civil law tradition, the outcome is determined, and should only be evaluated, in terms of the logic of its deduction from the provision of written law.[39]

For example, explicit economic reasoning is rare – not to say absent – in the decisions of the French Cour de Cassation and would have been criticized if present. In that case, the abductive/hermeneutic function might be used by judges outside their courts as an intellectual game but not in their practice of law.

Common law judges, by contrast, are shapers of law and can take into account the policy impact of their decisions (except if we agree with what has been called a Langdellian approach to law or a Dworkinian view; according to these views, judges discover the law without creating it). Economics can help them first to gain a better understanding of what is at stake (abductive/hermeneutic function) and second to "choose" one option (heuristic function). There is also no impediment to using law

[36] Mahoney, p. 504.

[37] Mattei, p. 78.

[38] Mattei, p. 79.

[39] Mattei, p. 79.

and economics in order to justify their solution. This last use depends upon standards established by higher courts regarding the justification of a decision.[40]

For lawyers, the situation is close to that of a judge. Civil law's lawyers will search for legal solutions in "codes" and not outside the law (using economic or sociological or psychological argument). The heuristic function will then be of no help: they have to "apply" the law, not to "decide" it. If judges conceived their role as "applier of legal rules", lawyers would not refer to economic argument to justify advocated solutions because it would not have any influence on the judges. Indeed, in this crude system, there is no need for lawyers, except to establish facts. Like judges they are allowed to use the abductive/hermeneutic function of law and economics as a mental game or to "make sense" out of what they are doing but this use is not necessary for their daily practice.

Common law's lawyers are in an opposite situation. Since judges are aware that they are shaping the law, policy arguments used by lawyers can be of some influence (once again, it will depend upon what is "accepted" by higher courts). Thus, rhetorical and heuristic functions can be activated if accepted by judges. Since these two functions imply the abductive/hermeneutic function, all three functions of law and economics can be set in motion.

Concerning legislators, the situation is quite similar in both common law and civil law countries. Since they have power to decide, they have power to choose and economics can be introduced in order to make that choice (at an abductive/hermeneutic level or at a heuristic level). Of course, the rhetoric of economics can also be used to signal that they are pragmatic; or by not using them, to signal that they have "values" (which does not mean that the decision was made only according to these values; indeed rhetorical and heuristic functions are not necessarily linked). To take the example of France, impact assessments (consequentialist reasoning), like cost benefit analyses, are tools both for inquiring into the problem at stake, for justifying the need for legislative action (in that case, the rhetorical function is recognized), and for deciding what is the "best" legislation regarding one specific problem.[41]

Concerning scholars, the situation is also the same. Economics can be a mobilizing force to criticize existing rules, to prescribe reforms or to interpret the working of the legal system (all three functions can then be activated). However, the acceptance of this kind of reasoning will depend on what is conceived as "valid" reasoning by the scientific community[42] and the link between "valid" reasoning and how courts appear to decide a case should be taken into account. Indeed, if scholars are using economics, it is because they believe that it is a powerful tool, which can be used by legislators or judges in order to make (better) decisions or at least to have a better understanding of what is at stake.

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[40] Which is linked to the debate about the autonomy of law, *infra* (Sect. 2.3.2).

[41] For this interpretation of CBA, see Eric Posner and Matthew Alder, *New Foundations of Cost Benefit Analysis*.

[42] Thomas Kuhn, *La Structure des Révolutions Scientifiques*.

Even in a very crude appreciation of legal traditions, it is quite clear that law and economics can be used. What is changing is simply the "who". In common law systems all agents are concerned; in civil law systems, law and economics can be especially useful to legislators and exploited by scholars. The abductive/hermeneutic function (EAL as an interpretive system) however can influence all types of agents.

2.2.2 Law and Economics in a Less Crude Conceptualization of Legal Traditions

The extremely crude conceptualization of the common law/civil law divide laid out in the previous section has to be refined since the ideal type is far from the actual working of law in each legal tradition.[43] The blurring of differences can be explained by a transformation in comparative law:

> Under the impact of a dramatic worldwide intensification of a trans-national exchange and the movement of persons, goods, services, and capital, the work of all branches of the legal profession tends to become globalized. Legal scholarship has begun its search for a common core of legal systems, and thus has sought to redirect the emphasis of comparative law toward similarities rather than differences.[44]

In this section, I will concentrate on the main arguments but I will not present an exhaustive view (see references for more details). Since differences are blurring,[45] it will be clear that this divide is irrelevant with respect to the use of law and economics.

In civil law systems, "codes are no longer the most significant sources of law".[46] Portalis was aware of some limitations of the civil code. He said:

> A code, however complete it may seem, is no sooner finished than thousands of unexpected questions present themselves to the magistrate. For these laws, once drafted, remain as written. Men, on the other hand, never rest. They are always moving; and this movement, which never ceases and whose effects are variously modified by circumstances, continually produces some new fact, some new outcome. Many things are therefore necessarily left to the authority of custom, to the discussion of learned men, to the arbitration of judges.[47]

Moreover, written laws cannot be more precise than their medium, the language; and natural language is far from being unambiguous (the role of the theory of language that was developed in the last nineteenth century cannot be disregarded).

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[43] See for example Peter De Cruz, *Comparative Law in a Changing World*; Ugo Mattei, C*omparative Law and Economics*; Marie Claire Ponthoreau, *Droit(s) Constitutionnel(s) Comparé(s)*; for a divergent view see Pierre Legrand and Geoffrey Samuel, *Introduction au Common Law*.

[44] Schlesinger, p. 479.

[45] Except regarding procedure, see Oscar Chase et al., *Civil Litigation in Comparative Context.*

[46] Mattei, p. 83.

[47] Jean-Etienne-Marie Portalis, *Preliminary Address on the First Draft of the Civil Code*.

Judges are thus also shapers of the law since they have the power to transform normative propositions into norms through their power of interpretation, which is not unconstrained.[48] They have to interpret a legal proposition that refers to "the reasonable man", "causality" or "fault" (they are sometimes "forced" to refer to them, but the law does not entirely constraint the "meaning" of each of these legal category). Judges are "co-legislators" and plainly participate in legal changes. Indeed, it is now impossible to practice property law or contract law without knowledge of relevant legal decisions; what is then published as a French "code civil" includes relevant legal decisions adopted principally by the French Cour de Cassation (which represents more than 70 % of what is in the "code civil").

However, in order not to sound arbitrary, the best strategy for judges is to "show" that this or that interpretation is the sole possible, reasonable or acceptable one. Sometimes, judges are "creating" new rules: in France it is the case of "les principes généraux du droit" (general principles of law), "les objectifs à valeur constitutionnelle" (goal that are recognized as constitutional ones). French civil liability law has been developed mostly by the judges, therefore it can be said that civil law judges are also making laws. Nevertheless, an important difference still survives regarding justifications that are considered as valid (in France for example, the idea is to find the solution and not a solution to a legal dispute). Conversely Calabresi noted:

> We have gone from a legal system dominated by the common law, divined by courts, to one in which statutes, enacted by legislatures, have become the primary source of law.[49]

Statutes have to be applied and, as such, economics can only be used when their interpretation leads to at least two different options (so law and economics is more relevant for appellate judges and generally in higher courts). In common law, some codes are present: for example the uniform commercial code. Restatements are of a different nature but the general philosophy is to "clarify" the common law.

Moreover, precedents are "binding" and have to be interpreted in order to identify what a relevant "precedent" is for the legal problem at stake. Thus judges in common law systems are also relatively limited, even when no statute is relevant, but their constraints do not lie in "codes" but in "precedents" (that they have to interpret) and in justification methods that are more "open" (the logic of equity is not the logic of a rational "code"). Constraints, then, reside in justification methods and not in "real" reasons. Holmes remarked:

> But in fact lawyers, like other men, frequently see well enough how they ought to decide on a given state of facts without being very clear as to the ratio decidendi.[50]

This blurring of differences leads to an extension of the "who" can use law and economics (and to a necessary criticism of the normative use of these differences

[48] Troper, *La Théorie*, pp. 9–11; see also Michel Troper, *Le Droit et la Nécessité*.

[49] Calabresi, p. 1.

[50] Holmes, 'Codes', p. 1.

between legal traditions). Of course, nothing changes for legislators or for scholars except that the recognition of inevitable policy decisions can lead to the acceptance of the rhetorical function of law and economics. It will also make them be more careful in drafting laws (the more precise they are, the more judges are supposed to be limited). But for judges, law and economics is now a possible tool. Indeed, in a civil law system, judges sometimes have to create law or to decide between two different interpretations; in order to make choices, they can use law and economics both at an abductive/hermeneutic level and at a heuristic level.

If law and economics can be used in both legal traditions, this legal aspect is not what matters. If it were the case, it would be difficult to explain differences inside each legal tradition. My objective in this article is to focus on legal characteristics that influenced the perceived value of law and economics. The use of this divide was misleading but revealed legal characteristics that matter with respect to the acceptance of law and economics within a legal system.

2.3 The Relevance of Legal Characteristics for Assessing the Perceived Value of Law and Economics

> Since the economics side of law and economics is the same all over the world, it is on the legal side that we may find resistance to the worldwide expansion of this scholarship.[51]

However, the legal side does not restrict itself to legal traditions. In order to assess the perceived (because reality cannot be "proven") value of law and economics, three key characteristics might be advanced: perceived instrumentality (of law), perceived autonomy (of legal reasoning) and perceived freedom (of judges). In this section, I will review each of them[52] and assess their possible influence on law and economics' reception. Only the last one was addressed in the civil law/common law explanation of the relevance of law and economics (but not in all of its aspects).

Ideally it could be possible to map the "perceived" legal systems around these three "axes" to predict the "future" of law and economics in each legal system. Nonetheless, the traffic is not "one way" since what is perceived is also influenced by theory.[53] The fact that law and economics has an influence on how the law is perceived is self-evident. Posner, for example, stated that "[w]hen I was a student the law seemed an assemblage of completely unrelated rules, procedures and institutions. Economics reveals a deep structure of law that has considerable coherence",[54] which means that it "transformed" his views and approach to law. A better view would be a dynamic interaction between perception, theories and facts, which is far too complex to be developed in this article.

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[51] Mattei, p. 78; contra Ramseyer, pp. 1470 et seqq.

[52] See Sects. 2.3.1, 2.3.2, and 2.3.3.

[53] One extreme view is developed by Sapir, p. 69, and more generally by "constructivists".

[54] Posner, *Frontiers*, p. 40.

Of course, these three characteristics can be linked. For example, if it is believed that judges have some freedom in their decisions and the law is not seen as instrumental (at a "norm" level[55]), law and economics might have difficulties to prosper in such a system (at least for its rhetorical function). However, for our argument, it is not necessary for it to be so and each characteristic offers a possibility to use law and economics. I am trying to develop a possible "mapping" of legal systems by reducing the problem to each of the identified dimensions; but the "global" view has then to be interpreted.

2.3.1 The Relevance of Perceived Instrumentality of Law

Focusing on the common law/civil law divide missed a determinant legal characteristic for the acceptance of law and economics: instrumentalism. Instrumentalism is neither a common law phenomenon (it is perfectly possible to envisage a non-instrumental approach to common law; indeed it was the case before the nineteenth century[56]; instrumentalism is then an "historical" product instead of a U.S. product even if "[...] legal culture there is strongly instrumental".[57] It also inspires civil law countries at least at the legislative level (impact assessment is a manifestation of this way of thinking about the law) and, in a way, also at the adjudication level. Tamanaha also remarks:

> An instrumental view of law is so taken for granted today that it rarely evokes comment, but in the 1960s and 1970s its novelty in legal education was recognized and prompted expressions of concern.[58]

This remark is particularly interesting for our purpose since law and economics developed its approach in the 1960s and 1970s. In the same vein, Posner remarks:

> The difference from Langdell's day – a difference that was the legacy of Holmes and the legal realists – was that law now was recognized to be a deliberate instrument of social control, so that one had to know something about society to be able to understand law, criticize it, and improve it.[59]

Instrumentalism means, crudely, that law is trying to promote something outside itself, in general social purposes (it is a means to an end and not an end in itself). A stronger definition of instrumentalism adds the idea that these social purposes are "deliberately" targeted (but determining who the architect is, is often

[55] *Infra* (Sect. 2.3.1).

[56] Tamanaha, pp. 11–23.

[57] Kornhauser, p. 31.

[58] Tamanaha, p. 101; see also Posner, 'Decline of Law', p. 761.

[59] Posner, 'Decline of Law', p. 763.

difficult). To be more precise, it is possible to distinguish between different forms of instrumentalism: rule instrumentalism (each rule is a means to an end), institutional instrumentalism (institutions are designed to "promote" social purposes) and systemic instrumentalism (the legal system as a whole is considered as instrumental).[60] These different levels point out the difficulty of saying that something is efficient or inefficient: a rule can be inefficient *ceteris paribus* in a system that is, as a whole, considered efficient; a rule can be inefficient *ceteris paribus* even if the institution whose purpose is to produce norms is considered efficient (and the reverse is also true).

Adopting an instrumental view of law will certainly promote the acceptance of law and economics; undeniably law and economics is "monotonously instrumental, examining in every context whether law is an efficient means to designated ends".[61] If law is seen as a means to an end, each legal rule or institution has a purpose; their consequences cannot be disregarded, and economics furnish tools to analyse these consequences (of course, it is not the only one: sociology, history or psychology can also be used; economics is especially relevant when a bad man's view is adopted and when there is only a prudential normativity of law); the problem is not only what "is" the law but what "are" the consequences of deciding in favour of one option (not only regarding the problem at stake but also regarding the legal system as a whole). Brian Bix indeed observed that "[p]art of the power of economic analysis is that it presents a largely instrumental approach, which fits well with the analysis and evaluation of law: it forces the question, do these legal rules achieve the objectives at which they aim, and would alternative rules do any better?"[62]

Economics can be used, for example, to gain a better understanding of how people will possibly respond to the introduction of a new rule or to assess the relative efficiency of different options that are considered to "solve" a problem (and traditional legal reasoning does not offer tools which are as systematic as the ones offered by economics). In such a system, the aim of law shapers is to (try to) choose "rationally", which means according to consequences (and this paradigm shift is a consequence of the new scientific spirit that developed from the seventeenth century which explains the world in terms of cause and consequences). Note that this does not necessarily imply that judges have to decide cases with this instrumentalism in mind; it may just as well be the case when the law is seen as instrumental but institutional instrumentalism requires that judges "apply" the law without considerations of policy analysis.[63] However, it is clear that adopting an instrumentalist view of law will lead to the development of tools in order to inquire into consequences and will justify the use of these tools. Moreover, such an approach

[60] Kornhauser, p. 33.

[61] Tamanaha, p. 118.

[62] Bix, *Jurisprudence*, p. 190.

[63] This view is developed by Friedrich Hayek, *Law, Legislation and Liberty*; for example, to promote legal certainty.

to law will lead to the questioning of existing legal rules and institutions to assess their relative efficiency or to reveal what "goal" they are promoting (we presuppose then that law has a reason; this inquiry can be mostly a scholarly task). If law is a tool of social engineering, it will also be possible to explain choices through the rhetoric of efficiency and rationality (which seems more "scientific"). Of course, to use this rhetoric the power to "decide" in such a way must be accepted.[64]

Even if I emphasized rule instrumentalism (because it is the one most promoted by mainstream economic analysis of law which, in general, assumes that shapers of law are promoting the general interest; called policy analysis by Kornhauser), other instrumentalist dimensions can be (and have been) questioned by law and economics (for example the relative efficiency of common law versus civil law systems; the reason for an independent judiciary power, the efficiency of the legislative power – can this institution promote general interest? –, and more generally, if one specific institution is efficient regarding one specific goal). These dimensions are mostly analysed by the political economy school.[65] By contrast, "[i]t is characteristic of non-instrumental views that the content of law is, in some sense, given; that law is immanent; that the process of law-making is not a matter of creation but one of discovery; [. . .] that law is, in some sense, objectively determined".[66]

In such a case, law and economics is irrelevant because there are no choices in this natural law's view (the question is still problematic when considering Aristotle view of "natural law" because consequences are not disregarded). Taking into account consequences of a legal rule or speaking the language of efficiency is incompatible with a non-instrumental view of law; what matters is "justice" and not its consequences (death penalty is not criticized for being inefficient but for being cruel, inhuman, etc.); the problem of course, and the reason why this view tends to decline, is the impossibility to prove "scientifically" what justice stands for. In a sense, a non-instrumental system focuses its attention on the content of law and not on the reasons or consequences of this content (categorical imperatives are incompatible with law and economics reasoning). According to this view, the question "why" is problematic since it signifies that law is a "means"; asking this question forces us to look outside legal materials: "a defense of law in purely legal terms would be circular, and therefore we need to look outside the law for a defense".[67] Of course a legal theorist can use law and economics to hypothesize about the efficiency of such a view but judges, lawyers and legislators will not look at law and economics in order to decide or to interpret the legal system.

This distinction between instrumental and non-instrumental conceptualization(s) of legal systems can also be applied to micro-divides regarding branches of law. The less a branch of law is conceived as linked to "morality" or "justice" (so the more it

[64] *Infra* (Sect. 2.3.2).

[65] See Kornhauser, pp. 39–45.

[66] Tamanaha, p. 11.

[67] Sunstein, p. 93.

is conceived as purely instrumental), the more the law and economics' approach will be considered as valid. For example, Fiscal law is conceived as a purely instrumental branch of law; so is competition law or procedural law. Economic reasoning will then be more probably considered as relevant and indeed is not really criticized on these matters. By contrast family law or civil rights law is more closely linked to moral views (marriage is not purely a legal status and a contract, it is more than legal consequences for some people; liberty cannot be "defended" through consequentialist reasoning without depriving it of its "value") and its acceptance is more difficult (for citizens, lawyers or judges). Labour law is also reticent to law and economics since most of its practitioners do believe that economics is losing "important values".

The problem of acceptance of law and economics is far more concerned with the heuristic and the rhetorical function of law and economics (since they are used to decide or to change things). There is no impediment to use the abductive/hermeneutic function in all areas of law, even if not conceived from the point of view of its users as instrumental. Moreover, I believe that this function is vital when a non-instrumental view of law is dominant since it will force legal agents through reflexivity to inquire about their own methodology(ies) and to answer to trade-offs that are pointed out by the economic analysis of law.

2.3.2 The Relevance of Perceived Autonomy of Legal Reasoning

The influence of the autonomy of legal reasoning on the perceived value of law and economics is related directly to its rhetorical function (obviously if the autonomy of law means the impossibility to use the rhetoric of economics in justifying a legal position, this function of law and economics would not have any practical relevance) and indirectly to its heuristic function (because a perfect autonomy of law will lead to only one solution: that justification and decision cannot be separated). The question of the autonomy of law is irrelevant to the possibility of use of the abductive/hermeneutic function. As far as legal reasoning is concerned, the question of autonomy will focus mostly on judges and lawyers. It will also have an impact on legal scholars (especially regarding their publishing activities). The autonomy of legal reasoning is indirectly relevant to legislators because they will have to take into account this "fact" in order to draft their statutes.

The question of the autonomy of legal reasoning is a recurrent question in legal theory. It will not be possible to give an exhaustive view of this debate. Simply put, the problem is to determine whether law is a discipline (with a specific methodology) or a domain (and in that case any methodology for analysing an object "law" is doing a "legal" analysis). More precisely, Bix identified four distinct claims, "legal reasoning is different from other forms of reasoning", "legal decision making is different from other forms of decision making", legal reasoning and

decision making "are sufficient to themselves, that they neither need help from other approaches nor would they be significantly improved by such help" and "that legal scholarship should be about distinctively legal topics".[68]

I will address the question of the autonomy and its relevance for law and economics through developments made by Posner.

In 1987, Posner wrote "The Decline of Law as an Autonomous Discipline" to promote the development of social sciences as legal tools. The importance of autonomy for law and economics was made clear. Indeed, if law is autonomous (according to his definition) it would be "[a] subject properly entrusted to persons trained in law and in nothing else"[69] so that law students only need to study "authoritative legal texts" and uniquely their content. In such a case, economic reasoning will be considered as "outside the realm of law" and will not be used by judges or lawyers; they have to apply the law, not to judge it, and to accomplish this task the knowledge of economics is of no relevance. Of course, even in such a case, it would be possible that normative propositions use economics references or "impose" the use "economics". However, this legal use of economics transforms the meaning of economic references; it is no more economics but law.[70]

If law is completely autonomous, it would be possible to decide a case only with knowledge of relevant laws and no two answers could be given to a legal problem (which presupposes the existence of good tools for interpreting legislative texts, precedents, etc.); legal reasoning would be like doing mathematics, it would be purely mechanical. Indeed, if two answers are possible (it is impossible to say that one is right and the other is wrong according to a common "standard" of evaluation), the choice of one answer could not be explained through law alone – by definition – so that "[w]e cannot rely on legal knowledge alone to provide definitive solutions to legal problems".[71] Judges will then have to use something outside "purely" legal reasoning. Thus, the problem of autonomy is related to the problem of indeterminacy of law and the perceived freedom of judges.[72]

Of course this conceptualization was developed by the realists in the beginning of the twentieth century and Posner is not saying more. They also argued for better knowledge of social sciences and especially economics:

> For a rational study of the law, the black letterman may be the man of the present, but the man of the future is the man of statistics and the master of economics [. . .]. As a step toward that ideal it seems to me that every lawyer ought to seek an understanding of economics. The present divorce between the schools of political economy and law seems to me an evidence

[68] Brian Bix, 'Law as an autonomous discipline'.

[69] Posner, 'Decline of Law', p. 762.

[70] The concept of market power for example is different used in the realm of law and in the realm of economics, see for details Christophe Le Berre, *Le Raisonnement Economique en Droit de la Concurrence*; Lionel Zevounou, *Le Concept de Concurrence en Droit*.

[71] Posner, 'Decline of Law', p. 767.

[72] *Infra* (Sect. 2.3.3).

> of how much progress in philosophical study still remains to be made[73]; [or] a lawyer who has not studied sociology and economics is very apt to become a public enemy.[74]

Others ask for a more "humanistic" formation:

> It is important to a judge called upon to pass a question of constitutional law, to have at least a bowing acquaintance with Acton and Maitland, with Thucydides, Gibbon and Carlyle, with Homer, Dante Shakespeare and Milton, with Machiavelli, Montaigne and Rabelais, with Plato, Bacon, Hume and Kant, as with the books which have been specifically written on the subject.[75]

The fact that there is more to legal reasoning than law is widely accepted. The problem remains in identifying when and to what extent it will be possible to implement such "outside knowledge" and more generally, its domain of validity (which is not our purpose in this article; only few comments will be made regarding this problem). Even if law is considered as non-autonomous, it is "obvious" that legal agents have to have knowledge of procedures, sources of law, principles, etc. for the quality of legal debate.[76] The problem then is not the autonomy or the non-autonomy, it is the relative perceived autonomy.

With autonomy (conceived as Posner did), law and economics is restricted at a practical level; without it, law and economics could be used or have a practical importance both in deciding and justifying a decision; its abductive/hermeneutic function will also be promoted to grasp the practical problem. However, the "could" is important; indeed, the fact that law needs to use materials that are considered as "outside of it" does not mean that law and economics will be used. It will then depend on the concept of law (and especially instrumentalism[77]) and on what is accepted as a "valid argument" (the relative autonomy of legal reasoning).

If law is not autonomous, the heuristic function could be applied even though it would be impossible to "know" if it had been used. For example it is possible to choose a solution according to efficiency and try afterwards to justify it according to moral philosophy or a specific interpretation "legal materials" that is not justified because at one point we are faced with the problem of choice. It could also perfectly be the case that the same reasoning could have been reached using non-economic considerations. In those cases, the abductive/hermeneutic function will try to shed light on the possibility of such hidden use by judges.

Regarding the rhetorical function, the real question then is not the autonomy but the perceived autonomy. Which kind of arguments can be applied (is accepted as a relevant argument) by lawyers and judges? Consequentialist reasoning for example is not absent of traditional legal reasoning,[78] and identifying clearly the difference

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[73] Holmes, 'The Path', pp. 469, 474.

[74] Brandeis, p. 470.

[75] Hand, p. 81.

[76] Posner, 'Legal Scholarship', p. 1324.

[77] *Supra* (Sect. 2.3.3).

[78] see Rudolf Ihering, *Law As a Mean to an End*; Neil MacCormick, *Legal Reasoning and Legal Theory*.

between a consequentialist reasoning and an economic analysis is not clear (so accepting the former did not imply the acceptance of the later). Is the problem simply one of vocabulary? Is the distinction only the consequence of the rise of economics as a discipline? This problem is even harder when the problem is to inquire into legal decision-making before economics arose as a discipline. Backhaus remarked that "[f]or Wolf, for instance, applying an economic analytical argument to a legal question was still a standard approach. Only after the disciplines had gone their separate ways would it seem natural for an economic problem to be met with an economic analytical tool, and a legal problem with the proper legal analytical tools".[79]

However, what does it mean to apply an "economic analytical argument" and how to identify it? The problem is solved when courts explicitly use social science doctrines, or are directly using (legalized) social sciences (especially if the field in which it was used is relevant[80]). When they do not, to which extent will they be "sensitive" to such elements? I believe that this question cannot be solved without a clarification of what "judging" means and if judging means using practical reason, economic arguments cannot be disregarded but should not be overestimated.[81]

2.3.3 The Relevance of Perceived Freedom of Judges

The common law/civil law divide was considered as relevant for the reception of law and economics through a distinction in the role of judges. In common law countries they were considered as co-legislators (so policy arguments where "acceptable") whereas in civil law countries they were supposed to be mere "interpreters" of legal materials (and should not make policy analysis of their decisions). This crude divide has been criticized in part 2 of this article: judges in both legal traditions participate in shaping the law and are in part constrained by the law.

They are restricted by the law, when the law is sufficiently determinate – when it provides justification only for a unique outcome. Cardozo noted in this sense that "[i]n countless litigations, the law is so clear that judges have no discretion. They have the right to legislate within gaps, but often there are no gaps. We shall have a false view of the landscape if we look at the waste spaces only, and refuse to see the acres already sown and fruitful. [...] Judges have, of course, the power, though not the right, to ignore the mandate of a statute and render judgment in spite of it".[82]

This absence of discretion might derive directly from the law (e.g. your request must be filled within 2 months and you filled it in the third then there is no

[79] Backhaus, p. 1.

[80] *Supra* (Sect. 2.3.3).

[81] Régis Lanneau, *Les Fondements Epistémologiques du Mouvement Law & Economics*.

[82] Cardozo, p. 129.

dispute as to the point of departure; however in such a case the law is supposed to exist before interpretation) or from the law plus a shared convention as to how to interpret it – which explains why even if the law is theoretically not determinate, it might be believed to be "practically" determinate because of a shared view as to how discretion is exercised (so shared that they are not perceived as a freedom). Posner said regarding this point that "I shall argue for objectivity as a cultural and political rather than epistemic attribute of legal decisions".[83] So, epistemic indeterminacy of law (and also absence of theoretical autonomy in legal reasoning) does not necessarily mean discretion (or perceived freedom). In these cases, law and economics tools are difficult to refer to (for their heuristic and rhetoric functions).

Nonetheless, the abductive/hermeneutic function of law and economic can be used. Assuming that judges are rational decision makers, they will not abide by the law if it is not efficient to do so (they are assumed to be free to choose) and they will consider that "[t]he past is repository of useful information, but it has no claims on us. The criterion for whether we should adhere to past practices is the consequences of doing so for now and the future".[84]

Thus it is possible to reinterpret a strict adherence to "past practices" (the respect for legal "conventions") as a "strategy" to promote efficiency or judge's goals. For example, they will respect legislative statutes or conventional interpretation of precedents because "[f]or judges to conduct guerrilla warfare against legislatures and higher courts is destabilizing, and in general a bad thing, but it is not always worse than the alternative".[85] They will also respect the "plain meaning of a statute or contract in order to protect expectations and preserve ordinary language as an effective medium of legal communication" if "the consequences are not catastrophic".[86] This approach is a "rationalization" of judge's behaviour, which is assumed to be free to "ignore the mandate of a statute and render judgment in spite of it".[87] However, any judge's behaviour can be reinterpreted in this way so that this explanation will seem "relevant" only if we subscribe to a certain conceptualization of their behaviour (using it is not descriptive, it is merely hypothesizing). This view also assumes that theoretically judges are free to do what they want even if constraints exist and the problem is to identify these constraints and to assess their relative value, a task that has not yet been done. Moreover, Posner recognized that different judges might weight consequences differently.[88] I therefore believe that the task of the abductive/hermeneutic function is really to identify these constraints. The assessment of their relative value however seems a far more difficult task and

[83] Posner, *Theory*, p. 26.

[84] Posner, *Law, Pragmatism and Democracy*, p. 6.

[85] Posner, *Law, Pragmatism and Democracy*, p. 71.

[86] Posner, *Law, Pragmatism and Democracy*, p. 82.

[87] Cardozo, p. 129.

[88] Posner, *Law, Pragmatism and Democracy*, p. 71.

assumes that there is one. Posner indeed recognized that "[t]here is no algorithm for striking the right balance between rule of law and case specific consequences, continuity and creativity, long term and short term, systemic and particular, rule and standard".[89]

Of course, when the consensus begins to weaken (that is a certain freedom is accorded to judges), economic reasoning could be used in order to promote different solutions or in order to back status quo (e.g. develop a new rationale). Heuristic and rhetorical functions can then be used. Indeed, since the law is not sufficient to "justify" one solution, something else has to be used. It will also be easy to explain through the abductive/hermeneutic function why a judge is "breaking" status quo.

When discretion is fully accorded to judges because of a recognized causal indeterminacy of law that cannot be solved through shared conventions,[90] economic reasoning can be used to promote a solution (because it is a way to "justify" it); especially if "pragmatic decision making" is valorised. This pragmatic decision-making recommends "bas[ing] action on facts and consequences rather than on conceptualisms, generalities, pieties, and slogans".[91] Of course, this view is linked to an instrumentalist concept of law. If only judges or lawyers are favouring this, they will decide (or advocate) according to consequences but they will justify (or advocate) according to a different rationale (e.g. they will mask their freedom or the foundation of their choice behind a "legal" necessity; only abductive/hermeneutic and heuristic functions will be applied). If the rhetoric of economics is accepted (judges are free to justify in their own ways), they will also make use of the rhetorical function.

2.4 Conclusion

The common law/civil law divide appears irrelevant for assessing the relative value of law and economics in a legal system. Indeed, even in a very crude understanding of this divide, law and economics reveals itself useful, at least at some levels or for some agents. Using this divide, however, requires research into legal determinants of law and economics acceptance.

I tried in this article to identify these determinants that transcend the civil law/common law divide: instrumentalism of law, autonomy of legal reasoning and freedom of judges. I also show that the abductive/hermeneutic function of law and economics is relevant whatever the legal system considered. So, there is no theoretical legal impediment to a wider reception of law and economics in European civil law countries and especially in law schools.

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[89] Posner, *Law, Pragmatism and Democracy*, p. 64.

[90] Especially emphasized by realists, Brian Leiter, 'Legal Indeterminacy'.

[91] Posner, *Law, Pragmatism and Democracy*, p. 3.

The framework developed in this article is a theoretical framework. Nonetheless it could be tested and I believe that it could also explain differences in the reception of law and economics in different legal systems. There is much work that remains to be done.

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Chapter 3
Comparative Study of Legal Reasoning in Swiss and UK Courts

Illustrated by Health Care Rulings

Lynn Watkins

Abstract With the ever-aging population, the increased financial burden to provide health care fulfilling the State's obligations under the internationally recognized right to health, is growing. This increasing pressure on the policymakers to balance the requirements arising from the right to health and the inherent costs is evident. The cost of rights and liberties is an obvious convergence point between law and economics. This essay aims to illuminate this convergence point and investigate the relative openness to law and economics in a common law and civil law system both striving to fulfill its international human rights obligation.

3.1 Right to Health and Health Care Economics

3.1.1 Right to Health

The concept of health derives from two different disciplines; medicine and public health. Medicine primarily focuses on the health of one individual, while public health is defined as "what we as a society do collectively to ensure the conditions in which people can be healthy".[1] The World Health Organization (WHO) defines health as "not merely the absence of disease but also physical, mental and social welfare."[2] This definition has moved the focus away from a limited pathology-based perspective to a more encompassing idea of "well being".[3]

[1]United States Institute of Medicine definition of 1988.

[2]The World Health Organization, *The Constitution of the World Health Organization*.

[3]Mann et al., 'Health and Human Rights', p. 8.

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There are numerous international and regional legal instruments, which recognize the "Right to health" as an indispensable right of all human beings.[4] According to the UN General Comment No. 14 (2000) every human has a right to the "highest attainable standard of health conducive to living a life in dignity". The right to health means that State parties are obligated to respect, protect and fulfill this right. This obligation to fulfill requires States to facilitate, provide for and promote health.[5] They must therefore:

- Ensure the right of access to health facilities, goods and services on a non-discriminatory basis.
- Ensure equitable distribution of all health facilities, goods and services;
- Adopt and implement a national public health strategy and plan of action, on the basis of epidemiological evidence, addressing the health concerns of the whole population.[6]

The obligation to protect requires the States to adopt legislation or by means of other methods ensure equal access to health care and health-related services provided by third parties and to ensure that privatization of health care does not infringe on the availability, accessibility and quality of health care available.[7]

Every health care system only has finite resources available and must strive to manage these resources in order to maximize the health gain of the population.[8] These resources include infrastructure, human resources and in particular medicines.[9] It is therefore prudent to apply economic methods in health care-policy decisions.

Elements of the right to health are legally enforceable[10] and States should provide some framework for accountability and remedial methods.[11] Domestic courts are increasingly confronted with cases dealing of accountability for the obligations

[4]For example, Art. 25 of the Universal Declaration of Human Rights; Art. 12 of the International Covenant on Economic, Social and Cultural Rights; African Charter on Human and Peoples Rights. For a more extensive list see Office of the United Nations High Commissioner for Human Rights, *The Right to Health*, pp. 9 et seq.

[5]UN General Comments No. 13.

[6]These core obligations are listed in the UN Commentary No. 14 and base themselves on, the Declaration of Alma-Ata 1978, stresses the importance of access to health care and provides detailed requirements that primary health care ought to fulfill, which resulted from The International Conference on Primary Health Care, held on 6–12. September 1978.

[7]UN Committee on Economic, Social and Cultural Rights (CESCR), *UN General Commentary No. 14*, para. 35.

[8]Dowie, p. 247.

[9]For a detailed discussion on the cost of rights see Stephen Holmes and Cass R. Sunstein, *The Cost of Rights, Why Liberty Depends on Taxes.*

[10]UN Committee on Economic, Social and Cultural Rights (CESCR), *UN General Commentary No. 14*, para. 1.

[11]UN Committee on Economic, Social and Cultural Rights (CESCR), *UN General Commentary No. 14*, para. 59.

under the right to health. For example, the Supreme Court in Argentina held that the State must provide an uninterrupted supply of antiretroviral drugs to individuals with HIV/AIDS.[12]

3.1.2 Cost-Effectiveness of Medical Treatment

From the discussion above, states must strive to provide health care facilities and services, which are accessible and of good clinical quality.[13] Treatments must therefore be both clinical effective and remain cost effective. When health care-policy decisions are made, both scientific and economic evaluations of treatments must be taken into account.

Clinical effectiveness is a scientific evaluation. Here the outcome of a specific new treatment is compared to the results achieved by the old treatment. A better result in comparison to the older treatment means that the new treatment is clinically more effective. For example, if a new medicine reduces blood pressure to a healthy range in half the time as the old medicine, it would be classified as clinically more effective in comparison.

The cost-effectiveness of a particular treatment is an economic evaluation and allows policy makers to decide whether the treatment should be made available in the health care system.[14] In other words it helps to answer the question: would providing the treatment within the health care system maximize the health of the population and remain an efficient use of the finite resources available?

Quality Adjusted Life Year Assessment Method

A common indicator for the cost-effectiveness of a given medical treatment is the quality adjusted life year (QALY). The underlying hypothesis is the assumption that 1 year of life lived in perfect health is worth 1 QALY. The QALY combines both quantity and quality of life. The health status is assigned a number between 0 and +1, where 0 would equal death and 1 perfect health. This value is then multiplied by the years lived in that state of health. The figure assigned to the utility function (quality) is calculated by the analysis of specialized questionnaires

[12]Supreme Court of Justice, *Asociación Benghalensis y otros v. Ministerio de Salud y Acción Social*, case 323:1339, 1 June 2000.

[13]Office of the United Nations High Commissioner for Human Rights (OHCHR), *The Right to Health*, p. 4.

[14]Dowie, p. 245.

completed by patients and health care professionals. The EQ-5D[15] is one of the most commonly used standard questionnaires in assessment of the health status of a patient in order to assign the quality value., In comparison to clinical effectiveness studies, which simply analyse the presence or absence of scientific values, such heart pressure or other tangible values, the data collected by EQ-5D questionnaires allow the sociological as well as psychological aspects of the individual's perception of health to be included in the assessment. This approach is more in-line with the WHO's definition of health.

Using such questionnaires however does have its drawbacks. Due to the rather subjective nature of asking individuals to assign a value between 0 and +1 on how they perceive their health there is potential for error. As an example, if a patient develops multiple sclerosis, a debilitating autoimmune disease, an individual who has lead a very active life previously will perceive their lack of mobility as worse compared to an individual who is used to a more sedentary lifestyle. The illness itself can also give rise to difficulties when conducting such surveys. An Alzheimer patient may not be in a lucid enough frame of mind to answer the questions correctly. Nor is it always possible for the caregiver to correctly assess on the patients behalf.

QALY as a Suitable Indicator?

The use of QALY as an indicator in cost-effectiveness of medical treatment is greatly debated. John Rawles in his essay "Castigating QALYs" points out the greatest flaw of QALY from a physician's point of view, by showing that "in the calculation of QALYs the implied value of life is no more than the absence of suffering".[16]

Using the allocation of a value of 0 for death and +1 for a healthy life means that the point between valuing life and the quality of life both converge at 0. He argues that the assignment of the value of +1 for no suffering would "equate the value of life with absence of disability or distress".[17] Furthermore, he adds that a method for the "distribution of resources by the best value for money, however assessed, is inequitable".[18] Instead, he proposes that the distribution should be based on the need due to the degree of suffering and applying a higher priority to the objective: prolongation of life.[19] In direct response to John Rawles, Gavin Mooney argues that while QALY as applied today requires improvement, it remains a good tool to measure the cost-effectiveness of health care.[20]

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[15]EuroQol Group is a network of international, multidisciplinary researches, who jointly developed this standardized questionnaire for the purpose of describing and valuing health-related quality of life.

[16]Rawles, p. 143.

[17]Rawles, p. 146.

[18]Rawles, p. 143.

[19]Rawles, p. 147.

[20]Gavin Mooney, 'QALYs: Are they Enough? A Health Economist's Perspective'.

Not only the methodology can be problematic but also the ethical implications are greatly debated. The use of QALY by institutes such as the National Institute for Clinical Excellence in the UK, means that a particular therapy can be classified as cost-ineffective even though for some people it may bring maximum benefit. In other words, there is inadequate calculation or assessment of the health benefit forgone by some for the health gained by others when allocating resources by means of QALY.[21]

As has been shown above, the use of QALY as a tool in health care policy is very controversial. Not only with regards to the methodology employed but also the obvious ethical implications of such calculations. The debate discussed so far has predominantly been from the medical and economic perspective. Attempting to assign a value to a human life in itself is highly controversial. The belief in the "sanctity of life" means that any human life regardless of any physical or mental deficiencies is of absolute or infinite worth.[22] This would imply that a human life should be saved at any cost. It is impossible to assign a value to an actual human life, however, it is accepted that such a value can be placed in an abstract or statistical sense.[23]

Relevant for this essay however, is how the legal systems approach this problem. This shall be discussed from a comparative point of view by looking at how the UK Court and the Swiss Federal Court approaches this question.

3.2 Common Law System

To understand how the problem of cost-effective health care is handled in a country with a common law system we shall use the United Kingdom as an example. First we shall outline how the health care system is structured before discussing a case confronted with the question of cost-effectiveness of treatment and the allocation of funds for a particular individual requiring such treatment.

3.2.1 Overview of the UK Health Care System

The National Health Service Act of 1946 passed by the Parliament, was based on the founding principle that there should not be a national health insurance but that the funding for health care should come directly from the taxes paid. With the growth of

[21] For further discussion on this debate see John Harris, 'NICE is not cost effective'; Karl Claxton and Anthony J. Culyer, 'Rights, Responsibilities and NICE; A rejoinder to Harris'; Paul Anand and Allan Wailoo, 'Utilities versus Right to Publically Provided Goods: Arguments and Evidence from Health Care Rationing'.

[22] Brech, pp. 209 et seq.

[23] For a comprehensive discussion on the issue surrounding placing a value on human life, see Balz Hammer, 'Valuing the Invaluable?'.

the ageing population, the ever increasing costs of medical care, the original Health Care Service Act and the resulting NHS has undergone many reforms to optimize the services it provides, while fulfilling the need to reduce public spending.[24]

The management of hospitals along with various aspects of the health care system is carried out by so called Trusts. These Trusts are not trusts in the legal sense of the word, but represent an organisational unit within the health care system. They are therefore not private organisations but a part of the public sector and therefore a public authority. The Primary Care Trust manages all the services associated with the initial contact a patient may have with the health care system. This includes, general practitioners, dentists, pharmacists among others. Each Primary Care Trust is allocated a certain area and is responsible for the management of the health care services within that given area.[25] The Department of Health allocates funds to each of the Primary Care Trusts depending on the "relative needs of their population".[26] The decisions on how this money is then best spent remains with the Trust. It is therefore at their discretion which medical treatments for a given individual within their Trust Area should be covered by the Trust. It is clear, that a public authority, with a finite budget, must allocate its funds to achieve the "maximum advantage of the maximum number of patients".[27]

This ability for each Primary Care Trust to decide how its funds are to be allocated gave rise to what is commonly referred to as the Post-Code Lottery. As each Trust can allocate its budget to satisfy the requirements it sees fit, a discrepancy arises between the spending on various treatments according to the catchment area of a Trust. For example, in the year 2006–2007 Knowsley PCT spend £ 152 per head on cancer treatment compared to Bedfordshire PCT, which only spend £ 44 per head that year.[28]

While some discrepancy can be explained by population and other environmental factors, it is clear that some central guidelines are required. The National Institute for Health and Clinical Excellence (NICE) was established 1999 as a central agency of the NHS responsible for the development of guidance "to ensure quality and value for money".[29] The guidelines published by NICE help in the decision making process on fund-allocation.

The measurement of clinical effectiveness and cost-effectiveness is part of the so called "technology appraisals" that the NICE conducts when developing treatment guidance. To do this, NICE collects data from patients, healthcare givers and other scientific resources including the manufacturer. The reports are then presented to

[24] Brief History of the NHS.

[25] NHS Authorities and Trusts.

[26] NHS Finance and Planning, Allocations.

[27] R v Cambridge Health Authority ex parte B [1995] 1 WLR 898.

[28] Appleby and Gregory, p. 5.

[29] About NICE.

the Appraisal Committee, an independent advisory body, which will then give recommendations on the clinical and cost-effectiveness of treatments to be used by the NHS.[30]

NICE calculates the cost-effectiveness of a new treatment as the cost of the drug or treatment per quality-adjusted life year (QALY). By its own guidelines, a treatment which costs more than £ 20 000–30 000 per QALY is not considered as cost effective.[31] The QALY values used by NICE are supplied by EuroQol.

PCT's rely on the guidelines issued by NICE. However, applications for funding of individual cases with exceptional circumstances are possible. Each PCT must institute a board charged with the role of deciding such exceptional cases, as well as provide some form of an appeals procedure.

3.2.2 High Court of Justice Decision Colin Ross v. West Sussex CO/8257/2008

To illustrate how the UK Court's use cost-effectiveness arguments in their decisions, the case of Colin Ross v. West Sussex Primary Care Trust (WSPCT) will be discussed. There are many more similar decisions but for this essay, this case illustrates the issue well.

In this case the Claimant applied for judicial review of the decision by the WSPCT not to fund a relatively new cancer drug, Lenalidomide. Mr Ross was suffering from multiple myeloma, a cancer of the blood plasma found in bone marrow. This type of cancer is not cure-able and treatment is aimed at slowing down its progression.[32]

As part of the treatment regimen the Claimant was receiving doses of the drug Thalidomide. A known side-effect of this drug is peripheral neuropathy, which had occurred and left him too debilitated to justify the continued administration of Thalidomide. In such cases, where the side effects of Thalidomide prevent its further use, the British Committee of Standards in Hematology recommend that Lenalidomide is administered in its place. However, as the use of Lenalidomide, though recommended, is not standard practice, the funding of such a course of treatment is subject to approval by the relevant PCT. Mr. Ross's treating Consultant Hematologist Dr. Faith Davies applied for the funding for Lealidomide in combination with two other drugs on the 31st of March 2008. At that time, the PCT denied the funding on the grounds that there was no "robust evidence" for the use of Lenalidomide and most importantly that "Lenalidomide has a very high cost in relation to the potential benefit".

[30] National Institute for Health and Clinical Excellence, Sect. 6.1.2.

[31] NICE Measuring Effectiveness.

[32] PubMed Health – Multiple Myeloma.

This initial decision denying the funding of Lenalidomide was appealed to the WSPCT Appeal Panel, and again denied. The Claimant's solicitors made a further submission to the WSPCT and included a report by Professor Sikora, a renowned authority on cancer treatment, which showed that the requested treatment was indicated in this case and that the Claimant's case was "exceptional" within the meaning of the WSPCT Policy. Again this submissions were rejected by the Review Panel, disagreeing with the claim that the Claimant's case was exceptional, maintaining that the clinical effectiveness would be too small to justify the expense and that "the evidence indicates that the proposed treatment is not cost effective per QALY". This decision was then challenged in front of the Court on the grounds that it was unlawful. The Court reviewed the decision with regards to the following three points:

1. Exceptionality;
2. Clinical efficacy;
3. Cost-effectiveness.

The Court held that the WSPCT's Policy was unlawful as its definition of the term "exceptional" is a contradiction of itself. The policy requires a patient to be unique in the sense that his case cannot be likened to another. However, as there is always the possibility of linking the circumstances or likeness of a particular case with another on the simple basis of similar symptoms, in practice this policy requirement meant that no case could ever qualify as "exceptional".

The Court held that the evidence submitted with regards to the clinical efficacy of the proposed treatment does fulfill the WSPCT's own test for clinical efficacy and therefore required review. Of interest for this study however, is the decision regarding cost-effectiveness, the Court held that the WSPCT Review Panel had erred in their calculation by applying a double discount for the 60 % partial response rate thereby including patients who would not respond with 1 years additional life. This resulted in a much higher cost for the WSPCT than would actually incur, should the WSPCT provide Lanolidomide to the Claimant and subsequently be faced with paying for the treatment for all potential patients in its' catchment area.

3.2.3 Analysis of High Court of Justice Decision

This Court ruling is a good example to discuss how the law, or rather the legal system, deals with information and arguments, which are not legal in nature but rather stem from a different discipline. In this case the information submitted to the Court is based on medical and scientific research as well as economic analysis. While the Court does not enter into discussion on the medical research presented, which clearly would be beyond its mandate and ability. It does grapple with the economic arguments presented in conjunction with cost-effectiveness.

While reading this judgment, it is clear to see that both the lawyers pleading the cases and the judge himself appear to be open to applying economic tools in their arguments and reasoning. Firstly in the submissions by the lawyers to the

Court and secondly in the structure of the decision, which is divided into three sections: (i) exceptionality, (ii) clinical efficacy and (iii) cost-effectiveness.[33] The question of exceptionality is legal issue. The Court can easily define on what legal grounds such a policy is built and which requirements must be fulfilled to satisfy the question of lawfulness.[34] The issue of clinical efficacy is reduced by the Court to a simple misunderstanding of the data presented to the WSPCT. The Review Panel charged with reviewing the application by the Claimant for the treatment held that the research presented in support of the treatment suggested did not satisfy the necessary criteria and did not show clinical efficacy. It is interesting to note, that the Court does preform some, though marginal, analysis of scientific and medical data submitted. It does not simply accept the submissions made by the parties but seeks to understand the clinical trials conducted on the use of Lanolidomide and by doing so understand the results of the data submitted. It then uses this information to form the basis of part its decision. The conclusion reached with regards to clinical efficacy is that the WSPCT had misunderstood the clinical study to such an extent as to deny clinical efficacy and was therefore wrong in its assessment. A strikingly bold statement when considering that the WSPCT review panel is constituted out of medical professionals while the Judge does not have this training or background but had to convene with specialist in the fields in order to understand both the study, the implications and then form his decision.

According to Lanneau, both the lawyers and judges in a common law system are able to apply economic analysis in the abductive/hermeneutic, heurisitc and rhetoric function,[35] which certainly seems to be the case here. There appears to be a general openness to converse and use terminology, principles and ideas found in other disciplines outside the law. This conversational repertoire encountered in this case shows the transformation of the terms used by lawyers. In fact, according to Ackermann, the current movement by law and economic scholars in the USA is to achieve exactly that, a new repertoire available to lawyers and open up the conversational possibilities while maintaining the integrity of legal reasoning.[36] As both the USA and the UK have a common law system, it stands to reason that the UK legal system is potentially equally open to such a change as the USA is.

Let us next turn to the question of cost-effectiveness. The Court in this decision does not itself introduce the use of such calculations. Rather, from a previous ruling that when deciding how to allocate funds it held: "the PCT should consider the nature and seriousness of each type of illness, and the effectiveness of various forms of treatment",[37] the principle of cost-effectiveness became part of the law and is cited as such in this decision. The principle of *stare decisis* has led to the integration

[33] *Colin Ross v. West Sussex*, § 66.

[34] *Colin Ross v. West Sussex*, § 38.

[35] Régis Lanneau, 'To What Extent Is the Opposition Between Civil Law and Common Law Relevant for Law and Economics?'.

[36] Ackermann, p. 933.

[37] R v. NW Lancashire HA ex parte A (2000) 1 WLR 977 at 991 E-G.

of an economic principle into the body of law regarding health care. There was no separate act of legislation, as would be the case in a civil law system, which will be discussed below.

As the health care system in the UK, is run and funded by the State, it is logical for the cost-effectiveness of treatments to be assessed by an administrative body with a specific mandate to do so. In the UK this role is filled by the NICE. The structure and function of the health care system was already discussed earlier in this essay. The Court is not required to question the practice of using QALYs or the system put in place per se but may question the lawfulness. However, in this case there was no question of the NICE overstepping its mandate and acting unlawfully.

Despite the debate surrounding the use of QALY, it is accepted practice when assessing cost-effectiveness in the UK Health Care System. This is supported by "The Guidelines on Conducting Technology Assessments" as well as the "Guiding Principles for Local Decision Making" which states: "Decisions should be based on the best available evidence, take into account the appropriate ethical frameworks and comply with statutory requirements." and under the factual criteria which should be considered they include the "relative cost and clinical effectiveness".[38] The Court therefore does not need to question the application of such economic methods as lawful but can accept this as being within the discretion and general acceptable practice of the health care authorities. It can rely on the submissions made by the parties with regards to their calculations of cost-effectiveness and so only preforms a supervisory role. In other words, the Court simply double checks the cost-effectiveness calculations performed by both the WSPCT and the Claimant without needing to create the criteria by which a treatment would be deemed as cost-effective for this by itself. The value of £ 20 000–30 000 per QALY is simply accepted by the Courts.

In this particular case, the Court recalculates the potential cost-effectiveness of the treatment the Claimant is requesting. The medical manufacturer of the treatment submits that the cost per QALY would be around £ 28 980.[39] This figure is not in dispute however, the actual likelihood of completing an entire additional life-year is. The Claimant had requested four cycles of the treatment with an option for a further 11 cycles should he respond to the treatment. The WSPCT had erroneously calculated the resulting costs too high assuming that further treatment would be required and not discounting the patients who, in the study on clinical effectiveness, had not responded with an additional 9.4 months of life. This flaw in calculation of cost-effectiveness is recognized and addressed by the Court.

Throughout the ruling, the focus on the individual case before the Court is heavily reiterated. The Court focuses on the Claimant's situation almost solely while ignoring the possible consequences for the entire health care system as a whole. Even during the analysis of the cost-effectiveness the overriding principle appears to be focused on the exceptionality of the case.

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[38] National Prescribing Centre, p. 19.

[39] *Colin Ross v. West Sussex*, § 88.

3.3 Civil Law System

Having seen how the health care system is structure in a country with a common law system, we shall now look at one within a civil law system, using the example of Switzerland. We shall first present an overview of the legal structure behind the Swiss health care system before analyzing a case to see how the Swiss courts approach the challenge of cost-effectiveness in health care.

3.3.1 Overview of the Swiss Health Care System

Since the 1.1.1996, the Swiss Legislation on Health Insurance (*Bundesgesetz über die Krankenversicherung*, KVG) has enforced obligatory health insurance on all people resident in Switzerland (Art. 3 KVG). It came to pass as a result of popular vote held in 1994, which replaced the previous legislation governing health and accident insurance. Under the previous legislation, insurers were able to set the insurance premium according to age and apply provisos to existing health conditions. Young insured were able to pay a lower insurance premium, which was however still higher than expected insurance risk they posed. This difference in cost was accruable with age. However, should they change insurer these accrued premiums were non-transferrable. This was seen as an inequitable approach as age and health issues were discriminated against. With the new legislation, individuals are free to choose the insurance company, who must provide basic coverage regardless of age or health,[40] thereby reducing discrimination.

The idea behind the KVG was to promote solidarity among the insured with regards to covering of health care costs. In both systems however, the insured still carries some of the cost of their medical treatment themselves.

The insurance companies are not state-run or owned but do require a license to be able to offer basic health insurance. In order to qualify for this license they must not be profit orientated and need to fulfill the requirements set out in Art. 12 KVG. Furthermore, they are subject to supervision by the Federal Office of Public Health (FOPH), which ensures that the insurance companies are complying with the relevant legislation and supervises the financial health of the company. The annual insurance premiums are set by the insurance companies and based on the expected health care costs of the coming year. These proposed premiums must then be submitted to the FOPH for approval by the end of July of the running year.[41] This not only ensures that the insurance company's financial health is secure but prevents

[40] Bundesamt für Gesundheit, *Gesundheitswesen*, p. 17.

[41] Bundesamt für Gesundheit, *Faktenblatt: Festlegung der Krankenversicherungsprämien 2013 und deren Genehmigungdurch das Bundesamt für Gesundheit (BAG)*.

any profit turnover in basic health insurance as stipulated by the KVG. Of course the insurers are free to offer additional coverage and insurance packages, which they may turn a profit on.

The basic insurance coverage that each individual living in Switzerland must have, does not cover all possible health care costs. The KVG sets out a catalogue of insured benefits in Art 25–31 and further states clearly that these must be "efficacious, appropriate, and cost-effective" (Art. 32 para. 1 KVG).

In view of Art. 32 para. 1 in conjuction with Art. 52 KVG, the FOHP generates a list of tariffs for the treatments accepted and therefore to be covered under the obligatory basic health insurance. A treatment, which is not on this official list, may be covered if: the illness could result in death or severe and chronic health problems, there is no effective alternative treatment and the "exceptional" drug has a very high therapeutic value.[42] This is referred to "Off-Label Use" and is the only grounds for an exception.

3.3.2 Swiss Federal Court Decision BGE 136 V 395

In this case, the Respondent was suffering from Pompe disease, a genetic condition in which the patient does not produce or insufficiently produces the necessary enzyme to convert glycogen. This leads to a build of glycogen in the body, particularly in the cells of the heart and muscles. To date, there is no cure for this disease, but through enzyme replacement therapy, and accompanying treatment, the disease is manageable. However, the greater the respiratory muscles are affected the lower the chances of long term survival. Symptoms of the disease can appear at any point in the patient's life, depending on the severity of the deficiency. The Respondent suffered from late onset or adult Pompe disease, which predominantly presented with respiratory difficulties and severe muscle weakness.

In dispute was the continuation of the Respondent's enzyme replacement therapy using the drug Myozyme. She had received treatment at a hospital, which included this drug and shown considerable improvement in her mobility and breathing ability. The Claimant, a health insurance company, covered the treatment for 6 months, but refused to continue to pay for ongoing use of Myozyme. The lower Court had obliged the Claimant to continue payment for a further 1½ years. This would mean that the Claimant would have to pay for a total of 2 years of treatment using the rather expensive drug Myozme. The cost of this would have been somewhere between CHF 750 000 and CHF 900 000. The Claimant appealed to the federal Court and requested it over-turn the ruling on two grounds. Firstly, that the cost of this treatment was not cost-effective and therefore did not comply with the principle enshrined in Art. 32 para. 1 KVG. Secondly, that there were no grounds which would warrant an "off-label use" (as described above).

[42]BGE 131 V 349 E. 2.3; BGE 130 V 532 E. 6.1; BGE 136 V 395 E.5.2.

The Court first considered whether the treatment in question would qualify for so called "off-label use". In particular, it discusses the definition of "high therapeutical value". However, it concludes that this does not apply in this instance because the extent of which Myozyme actually improves the condition is unknown, particularly with regards to continuation of treatment. In other words, the potential gain in health status by the continued use of the drug is too uncertain. To arrive at this conclusion, the Court relied on the findings of a study on Late Onset Pope's Disease, which held that the greatest improvement was found within the first 26 weeks of treatment. These initial 26 weeks of treatment were not part of the 1½ years worth of continued treatment in dispute before the Court, but had already been covered and paid for by the Claimant.

In a second step, the Court then went on to assess the cost-effectiveness of the treatment. It justifies this step in its analysis as a means to assess whether a treatment, which is not on the official list could be covered by way of exception. On the grounds that there are limited financial means available within a society, the distribution must remain fair and equal for all. This argument was based on the constitutional principle of equality before the law as held in Art. 8 para. 1 of the Swiss constitution (Bundesverfassung; BV). The Court held that no one individual should receive greater benefits than can be afforded to any other in a comparable situation. If every individual resident in Switzerland were to be entitled to treatment with an annual cost of CHF 750 000, then this would exceed the gross national product of Switzerland.[43] It would be impossible for health insurance companies to provide that level of coverage for all. Therefore, if the Claimant were to have the initial ruling upheld by the Swiss Federal Court then this would inevitably lead to the Respondent receiving preferential treatment as the same level of expense for treatment cannot be covered for all.

The Court concluded that the costs of CHF 750 000–900 000 in comparison to the benefits, even if the treatment was of high therapeutical value, far exceeds cost-effectiveness. The ruling of the lower court was therefore overturned and the Claimant no longer had to pay any additional treatment using the drug Mysozyme for the Respondant.

3.3.3 Analysis of Swiss Federal Court Decision

Though the principle of cost-effectiveness of a given treatment to be covered by the obligatory health insurance is stipulated in Art. 32 para. 1 KVG, the court held that there are no generally accepted criteria by which this is to be assessed with regards to health care,[44] and this has lead to legal uncertainty. Accordingly the court must then try to define some general principles or criteria by which such assessments should

[43] BGE 136 V 395.

[44] BGE 136 V 395 E. 7.6.

be conducted and act *modo legislatoris*.[45] This means that the court must first find a general rule, which can apply to all comparable cases in the manner in which the legislator would pass it. In other words, the court at this point acts as legislator to fill the gap. Creating a general rule, under which a case is to be summarized is not standard practice in the sense that it is only conducted by the courts in the rare circumstance that there is no rule set by the legislator.

The court proceeds to analyze other statutes and decisions, in which similar reasoning and decisions with regards to cost-effectiveness of health care treatment, or equitable valuation of human life have been made, thereby setting a framework of criteria as established by accepted practice. However, despite referring to multiple instances where decisions on cost-effectiveness were made, the court prefers to rely on fundamental legal principles; the principle of equality (Art. 8 BV) and the principle of proportionality.[46] A hesitancy to rely solely on economic arguments is clearly palpable in the manner in which the court approaches this problem despite the explicit reference in the code to an economic analysis. That courts may and even should, under such circumstances proceed to apply economic reasoning is accepted in Switzerland.[47]

By relying on these principles, the court is able to legitimize its attempt to set a maximum cost of a treatment that an insurer must cover under the obligatory health insurance policy for an individual per annum.

3.4 Comparison of the Swiss and UK Court Decisions

Of interest for this essay are the considerations of the courts surrounding the cost-effectiveness arguments. Both these cases show how economic arguments are finding their way into the law Switzerland and the UK. But by no means is this comparison sufficient to draw a conclusion for the receptiveness of either Switzerland or the UK legal system to economic analysis. This essay merely servers to show some of the development in this area. Further in depth study would be required to allow any substantiated conclusions to be drawn.

When looking at both of these cases, there is no doubt that both countries accept that there are finite resources available for health care. In the case of the UK, the finite resources are part of the state funds as a result of taxation. In Switzerland it is accepted because the obligatory health insurance providers must not be profit orientated, and the insurance premiums are calculated in accordance with the projected running health care costs thereby limiting the funds available.

It seems logical that when confronted which precisely this question, the courts turn to economic methods in their decision making process. However, both of the

[45] Stipulated by Art. 1 para. 2 of the Swiss Civil Code.

[46] BGE 136 V 395 E. 7.7.

[47] Kramer, p. 236.

decisions discussed shows that the manner in which this will be approached varies due to the nature of the legal system. Lanneau suggested that a simple opposition of civil law and common law as a means to explain why there is a difference in the receptiveness of a legal system to law and economics, is insufficient. In his essay "To What Extent Is the Opposition Between Civil Law and Common Law Relevant for Law and Economics?" he argues that the perceived instrumentality of the law, the perceived freedom of the judges, and the perceived autonomy of legal reasoning are better criteria to assess this receptiveness. Based on these three criteria, the cases discussed will now be analysed.

3.4.1 Perceived Instrumentality of the Law

The Swiss Federal Court, in trying to calculate cost-effectiveness of the treatment does not just take into account the specific drug in question in the specific case but instead, it compares the limits in quality of life that the Claimant is suffering to a multitude of conditions resulting in comparable limitations and symptoms. By doing so, the court scales up the potential cost for the health insurance company thereby highlighting the scarcity of resources and justifying the limit on spending. This is in direct contrast to the case before the UK court, in which the judge held that the PCT "exceptionality" policy is unlawful because it is impossible for the Claimant to show his uniqueness as "it will always be possible for another patient to emerge who is appropriately comparable".[48]

The UK court decision further highlights this difference in § 88, where the judge states that the argument of the increased costs for the PCT should it decide to commission the drug Lenalidomide for all myeloma sufferers in the future is not valid as it goes beyond the consideration of its Patient Individual Needs policy. In other words, the focus here is strictly on the individual before the court and not in the fairness of allocation of finite resources for all members of society. The court does not need to find a general rule applicable to all. Although it is accepted that cost-effectiveness must be a consideration when allocating funding for health care, the court rules in favour of the individual and explicitly ignores the potential financial impact for the PCT should it, as a consequence have to provide Lenalidomide for all myeloma sufferers.

In a legal system which has a high perceived instrumentality "each legal rule or institution has a purpose; their consequences cannot be disregard and economic furnish tools to think about these consequences"[49] it therefore follows that consequence-based reasoning in both the adjudication process and the legislative process must be readily accepted. However, this is a heavily debated topic which is

[48] *Colin Ross v. West Sussex PCT*, § 79.

[49] Régis Lanneau, 'To What Extent Is the Opposition Between Civil Law and Common Law Relevant for Law and Economics?'.

beyond the scope of this essay.[50] In UK court's decision, the instrumentality of the law is broken through by the principle of equity. Although it is accepted that cost-effectiveness must be a consideration when allocating funding for health care, the court rules in favour of the individual and explicitly ignores the potential financial impact for the PCT should it, as a consequence have to provide Lenalidomide for all myeloma sufferers.

In contrast the Swiss Federal Court places principle of equality for all above the individual needs. In its function as legislator, it builds its arguments by taking into account the consequences for the entire health care system should it hold that the obligatory health insurance should cover a treatment of such high costs. When acting as a legislator the court must find a general rule, which is applicable to all. It cannot therefore favour the principle of equity and reach a decision only taking into account the consequences for the particular case before it.

3.4.2 Freedom of the Judges

Traditionally, in the common law system, Judges had the role to not only adjudicate the cases laid before but by doing so to also find a generally applicable rule of law to be used in similar cases for the future.[51] Even with the growth of statues passed by Parliament, the rules of law and general principles developed by the judges over centuries, has not lost its value and is used when interpreting statutes.[52] Judges are therefore not simple interpreters of legislation but must be "finders" of the law. To do so they are relatively free, but are restricted by the doctrine of *stare decisis*, by which the decisions of a higher court are binding unto the lower courts. This more or less mirrors the ability of Swiss Judges to fill a gap in legislation acting *modo legislatoris* as described above.

However, in this case there is no need for the Judge in the UK case to find the law. Indeed, he is bound by *stare decisis* to accept QALYs and the other economic calculations used. The economic analysis required is clearly defined so there is no need for the Judge to question it. In fact, one could argue it has become standard practice and transplanted itself into the law regarding health care cost.

[50] In depth discussion on this is beyond the scope of this paper however, essays on this issue include: Klaus Mathis, 'Consequentialism in Law' which highlights the debate occurring in Switzerland, Germany and Anglo-American countries. Péter Cserne, 'Consequence-Based Arguments in Legal Reasoning: A Jurisprudential Preface to Law and Economics', which highlights the potential limitations to consequence based legal reasoning.

[51] James, p. 19.

[52] Field and Emson, p. 44.

3.4.3 Perceived Autonomy of Legal Reasoning

In the Swiss Federal Court case the court, for the purpose of defining general applicable criteria for the cost-effectiveness requirement, acts as legislator. It stands to reason that under such circumstances, socio-political considerations must be taken into account and legal reasoning "by itself" would be insufficient. In this case one could therefore assume that there is relatively low perception of the autonomy of legal reasoning under these circumstances in the Swiss Federal Court. However, in this specific case its hesitance to do so can be clearly felt and is shown by its' resorting to the fundamental legal principles of equality before the law and the principle of proportionality.

The UK Case, though in its conclusion an equity decision, still shows elements that the reasoning applied is not purely based on legal theory but the cost-effectiveness of the treatment in question is included in the consideration. The court's own calculation of the QALY based on the submissions and guidelines would lead to the conclusions, that here too, the perceived autonomy of legal reasoning is fairly low.

3.5 Conclusion

The UK and Switzerland have implemented a health care system aimed at fulfilling the obligations under the right to health. The UK approaches the obligation to provide accessibly health care to all and ensure that the health care is distributed equitably, by providing a completely State-run solution. Switzerland on the other hand, has a mixture between the privately run health insurance and the strong governmental regulation and oversight. Both of these systems appear to fulfill the requirements to provide primary health care as required by the UN General Commentary No. 14.

The health care system in the UK is funded by the State. The interest therefore, for the legislator to make clear provisions with regards to the allocation of funds is relatively high. Through various court decisions and legislation the system in place caters for economic analysis and focuses on the cost-effectiveness of health care treatment. The NICE as a government body, in charge of defining policy regarding clinical excellence and cost-effectiveness, has provided clear guidelines on how treatments are to be assessed. This therefore allows the courts, when faced with questions of health care economics to rely on the guidelines produced by NICE.

A judge in a common law system, while bound by legislation and precedent, is comparatively free to find the just and equitable solution to the case brought before him. The emphasis in the legal reasoning can therefore lie with the exceptions and specific case before the court when reaching a decision. That this allows non-legal arguments to be integrated and readily used becomes apparent when reading the case.

This is in stark contrast to the Swiss case. Although the legislation does explicitly state that health care covered by the basic health insurance must be cost-effective, the courts have no actual guideline on how this is to be assessed or defined. The Swiss court was forced to act *modo legislatoris* and find a general rule applicable to all, under which it could assign a value for the cost-effective treatment. In doing so, however, it shrouds the economic analysis in legal principles in attempt to justify and legitimize what it is doing.

Swiss courts do allow non-legal arguments within their legal reasoning but usually where it is explicitly held in legislation that these arguments are to be considered. Economic analysis such as the one confronted in the case described, are often encountered in other areas of law, for example governing commerce.[53] The use of economic analysis in law has indeed found its place in Swiss law.

In comparison, both of these countries and their legal systems show that law and economics is playing an ever more growing part. These two systems alone however, are not representative enough to allow a conclusion to be drawn for all common and civil law countries. But it is clear that the issue regarding allocation of health care costs have led courts to apply economic analysis in their reasoning.

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[53] Kramer, p. 236.

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Part II
Economic and Legal Thinking

Chapter 4
Homo Economicus Versus Homo Iuridicus

Two Views on the Coase Theorem and the Integrity of Discourse Within the Law and Economics Scholarship

Mariusz J. Golecki

Abstract This essay concentrates on the critical analysis and evaluation of some characteristics of the one of the most influential discourses in modern jurisprudence, namely law and economics. In this essay I will claim that the interpretation of the Coase theorem adopted by the law and economics scholars in American jurisprudence, specifically the implementation of the price theory and welfare economics within the lines of the M. Friedman's predictive social theory (*Homo Economicus* model) leads to the conditions of the legal discourse that are essentially different from traditional ones, especially those based on philosophical assumptions. It seems that the interpretation adopted by some European scholars is more analytical and reflects an explanatory rather than predictive approach to modelling and the application of economics to law (*Homo Iuridicus* model). Thus this essay intends to explore the distinction between the two approaches and to link it with the analytical description of direct and indirect modelling, as it has been recently been proposed by A. Halpin. The aim of the essay is thus to explain the distinctive features on the law and economics discourse in the US and in Europe as potentially superseding the traditional, narrative legal discourse and to address the question about the relationship between those two types of discourses.

4.1 The Legal Discourse as a Process of Linguistic Categorization

Since "in the beginning was the Word (J. 1,1)", language has always been located within the centre of jurisprudence. Moreover from the wider perspective *logos* and *nomos* seem to be mutually conditioned and indispensable. On the one hand,

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language serves as a mere tool of communication and social interaction, including the legal one. On the other hand, it becomes a theoretical problem for legal scholars. Thus, it is quite understandable that eventually the contemporary jurisprudence was strongly influenced if not shaped by the analytical legal philosophy, which naturally concentrated on law as a primarily linguistic phenomenon.

This fixation on linguistic aspects of law has become a remarkable feature of the British legal philosophy, which has been marked by the creation of methodological contours by J. Bentham and J. Austin and later on was profoundly transformed by H.L.A. Hart and imbued with the analytical approach of the so-called Oxford school.[1] This relationship between language and legal facts has been plainly described by H.L.A. Hart, who relies on the explanation provided by J.L. Austin, stating that:

> In searching for and finding such definitions we are 'looking not merely at words … but also at the realities we use words to talk about. We are using a sharpened awareness of words to sharpen our perception of the phenomena'.[2]

The key concepts and models of legal discourse were focused on the difference between the classical analytical theory of legal rules as commands (the command theory of law) and the more discourse and convention oriented approach proposed by Hart.[3] His work on The Concept of Law has become a benchmark for legal philosophy not only in Britain but also overseas. The common language became the beginning and often the end of any serious jurisprudential undertaking. Since the mid XX-century, philosophical studies truly became a study on language rather than on any other aspect of law. Accordingly, the scope of the analytical agenda has swollen since the introduction of the problem of the pragmatic aspect of speech acts by J.L. Austin,[4] L. Wittgenstein[5] and others. The concentration on a linguistic aspect of law has been strengthened by the institutional and systemic effect, since the commonly accepted practical purpose of legal sciences was limited to the interpretation of legal texts in different forms: statutory provisions, judicial rulings and last but not least, academic legal writings. The whole legal system can thus be sketched as a discursive system producing the definite meanings of legal utterances, the ultimate auditorium for setting out the content of law. Thus the legal actors communicate and eventually decide on the ultimate meaning of law, which becomes a product of discursive activity. This picture could be and in fact has already been attractively named by the members of legal academia. Discursive practice has been described as; a process of formation of the rule of recognition by H.L.A. Hart,[6]

[1] About the definition of law, composed out of basic conceptual elements, cf. Bentham, pp. 18–28; Austin J., pp. 9–15; Hart, pp. 13–17.

[2] Hart, p. 14, quoting Austin J.L., 'A Plea', p. 8.

[3] Hart, pp. 79–123.

[4] Austin J.L., *Do Things with Words*, pp. 14–40.

[5] Wittgenstein, § 38–133.

[6] Hart, pp. 100–110.

as application of coherent legal reasoning by N. MacCormick,[7] as the juridization of the practical reasonability and practical reasoning by J. Finnis[8] and J. Raz[9] respectively. All these reconstructions aim at grasping the focal point of law and normativity, adopting the so-called internal point of view and explaining law as an output of an institutionalized discursive process (*Homo Iuridicus* model).

Against this background the other methodological paradigm is conceivable. The alternative explains the law's normativity as an elusive problem. The linguistic categorization of law does not need anything in form of an internal point of view. The linguistic practices by lawyers and other actors could merely be explained on a behavioural level, the assumption being that the practices create the habit without any reference to the concept of reasons for actions. The linguistic categorization of the world in legal language or the language of law could alternatively be explained in terms of legal functions and legal institutions. The creation of legal concepts, legal forms and legal institutions could be treated as purely functional and pragmatic. Law serves some purposes and legal language has to reflect this sheer reality. These kinds of explanations of legal phenomenon have been widely accepted in American legal theory. They were established by the American pragmatists such as J. Dewey, W. James and C.S. Peirce, developed by American realists and methodologically strengthened by the founders of the law and economics movement such as G. Becker and R. Posner. Those lastly mentioned not only strengthened functionalism and institutionalism but also substituted the language of traditional language-oriented jurisprudence with the highly formalized language of neoclassical economics (*Homo Economicus* model).[10]

It seems that the difference between the American law and economics and the economic analysis of law originating in Europe at least to some extend reflects the tension between pragmatic (functional) and descriptive (analytical) approaches. This obviously does not mean that the more descriptive approach has by and large been adopted in the European law and economics. Actually it seems that major work in European law and economics is based on the application of the same methodology that was previously adopted in American law and economics. However, it seems that the methodological approach presented by European authors could possibly be elaborated as a wider, more interdisciplinary and explanatory project. Law and economics both in the US and in Europe tends to calibrate the conditions and determinants of this evolution, juxtaposing its positive and normative world-view with the one of traditional legal and political theory.[11] However, this

[7]MacCormick, pp. 152–229

[8]Finnis, pp. 260–343.

[9]Raz, pp. 3–36.

[10]Gary S. Becker, 'Crime and Punishment: An Economic Approach'; Posner, 'The Economic Approach', pp. 757 et seqq.

[11]For American perspective see Kaplow and Shavell, pp. 15–81. European perspective has been expressed by Mathis, pp. 185–203.

process may take different forms in the US and in European countries, as law and economics plays different role in European legal science. It seems to be obvious that the linguistic categorization of the world adopted by economics competes with the categorization based on morality and philosophy, the categorization previously adopted by law and legal sciences.[12] It also seems quite obvious that the entanglement between the philosophical narration, the moral normative theory, and its recognition within the framework of legal discourse is heavily dependent on the overlapping between the legal and moral vocabulary.[13] The concepts of rights, liberties, freedoms, obligations, duties etc. are operating on both legal and philosophical levels.[14] It is commonly believed that law and economics shares the same pattern of a general legal discourse. Moreover, it is quite common among some scholars to draw the origins of law and economics discourse from J. Bentham and his utilitarianism on the one hand and legal positivism blurred with political liberalism on the other.[15] It is thus necessary to investigate the similarities and differences between legal and economic discourses in law and economics. It seems that the best point of departure for such an undertaking is to begin with the exploration of the so-called Coase theorem, the basic foundation of the whole conceptual framework of the law and economics scholarship.[16]

4.2 Wonderful Worlds and Intriguing Models

The application of economic analysis to law is commonly associated with a well-known article of Ronald Coase and his theorem.[17] It is Coase who demonstrated to what extend the market depends on sound legal system, especially on the establishment of rights and liabilities.

The starting point for all those developments was the so-called Coase theorem on the changing relations between law and allocative efficiency. According to the theorem, in case of zero transaction costs, legal regulations on tort liability in case of nuisance are not decisive with regards to the final allocation of resources. The parties can always conclude an agreement changing the initial allocation of resources in such a manner as to remain effective from an economic point of view (the positive version of Coase theorem). As Coase explained:

> It is necessary to know whether the damaging business is liable or not for damage caused, since without the establishment of this initial delimitations of rights there can be no market

[12] Posner, *Frontiers*, pp. 2–10.

[13] Hart, p. 7.

[14] Coleman, pp. 33 et seqq.

[15] Posner, *Frontiers*, pp. 31–34; Mathis, pp. 105–111.

[16] On the pivotal function of Coase Theorem for law and economics see: Posner, *Frontiers*, p. 41; Coleman, p. 69; Mathis, pp. 53–69.

[17] Coase, 'Social Cost', pp. 95 et seqq.

> transactions to transfer and recombine them. But the ultimate result (which maximizes the value of production) is independent of the legal position if the pricing system is assumed to work without cost.[18]

The question remains whether this observation is correct. It is generally pointed out by many authors that the success of bargaining process cannot be automatically taken for granted. If the Coasean bargaining takes place on the market (a weak version of Coase Theorem), then the theorem itself does not add much to the general equilibrium theorem, and as such it is meaningless, even if true. If however, Coasean bargaining is supposed to take place under the assumption of bi-monopoly, where both parties have no market alternatives, then the whole problem seems to me more related to game theory rather than strictly economics. Concurringly, the Coase theorem seems to be too strong. As R. Cooter rightly observed, at this stage there is no ultimate proof of the Coase theorem, which could be either true or false depending on the circumstances.[19] Coase initially seemed to disregard the problem. However, in 1988, he was forced to admit that his initial assumption about the unproblematic character of the claim was shaken. Even if, as he claimed, the so called "Coase theorem" had initially been thought to serve as a merely heuristic device demonstrating the abstract character of neoclassical economics, the quality of such a device was still of importance. Besides, the ongoing engagement in debate and defence of Coase theorem has also seriously changed the attitude of Ronald Coase himself. It seemed to acquire greater importance as Coase devoted two chapters of his book *The Firm, the Market and The Law* to the explanation and defence of "his theorem". Not only the change of theorems' function seems to be puzzling both for historians of economic thought and adherents of law and economics movement. The additional source of confusion stems from the fact that some initial assumptions and observations put forward by Coase have been seriously altered.

Different authors tried to explain the potential contradictions concerning different characteristics of Coasean models in a more or less adequate way. Some of them claimed that the so-called zero transaction cost (ZTC) world played a role in the special heuristic devise. It is also common to distinguish between positive and normative variants of the Coase theorem.[20] On the other hand, the Coase theorem is sometimes understood as a claim for realism in economics and a plea for investigating the characteristics of the real world where transaction costs are positive, namely the positive transaction costs (PTC) world.

The problem of interpretation of the Coase theorem became a notorious feature of the European economic scholarship.

According to Uskali Mäki, the model of the ZTC world served as a kind of background for a critique of the role of abstraction in economics.[21] Coase did not intend to renounce abstraction and modelling. His position was rather based on the

[18] Coase, 'Social Cost', p. 104.

[19] Cooter, pp. 20–28.

[20] Posner, *Frontiers*, p. 6.

[21] Mäki, pp. 5–31.

distinction between horizontal and vertical abstraction. The first, albeit necessary, could lead to the creation of unrealistic theorizing. At the same time, vertical abstraction seems to be necessary for any economic analysis.[22] The methodological foundations of Coase's approach thus attracted much attention especially on the level of methodological discussion of the method in economics, whereas it did not play an important role for legal methodology.

Bingyuang Hsiung and Patrick Gunning observe that the Coasean methodological strategy was based on the "benchmark-comparison" method, consisting of the application of models of choice as benchmarks for the analysis of economic interaction.[23] They claim that Coase not only used some economic theories of choice, but also modified existing models, creating new benchmarks and applying them on two different levels of aggregation: where the number of interactions is small as in case of the contractual interactions between two parties or on the level of immense number of interactions, in case of market transactions and interactions between uncountable number of individuals. The difference between the two seems to play an important role for Coase. Furthermore, the difference between the individual interactions and market behaviour explains Coasean criticism concerning the extension of the price theory and the rational choice theory adopted as a model of nonmarket behaviour. According to Bingyuang Hsiung and Patrick Gunning, Coase criticised Gary Becker and Richard Posner precisely for this misapplication of the economic model of human behaviour.[24]

Elodie Bertrand attempts to explain some paradoxical characteristics of Coase theorem.[25] She emphasises that Coase criticised the attention devoted to explanation and understanding of the so-called "positive version" of Coase theorem. Coase particularly criticised an assertion concerning the assumption of zero transaction costs. However he has never stopped reasserting the validity of the theorem. This tension between apparent irrelevance and hidden significance of the positive version of Coase theorem could be explained by identifying different functions of the "Coase theorem" in Coase's scientific programme. According to Bertrand, Coase theorem plays three important, albeit different roles. Firstly it serves heuristic purpose, expressing the significance of transaction costs in economics. Secondly, the theorem has been applied as a benchmark for an extensive critic of the Pigovian tradition. Finally, it additionally serves as a source for normative statements pertaining to regulatory policy.

Appealing and interesting as they really are, the above-mentioned theories do not capture the internal link between legal and economic thinking, nor between legal and economic modelling in Coasean theorising. It seems that Coasean work contained many references to legal reasoning, judicial doctrines and institutional features of legal system and legal actors. Thus, it seems plausible to confront economic

[22] Mäki, pp. 5–31.

[23] Hsiung and Gunning, pp. 227 et seqq.

[24] Hsiung and Gunning, p. 228.

[25] Bertrand, pp. 983 et seqq.

theorising and legal modelling within a special and narrowly defined field, namely the interaction between law and market.

A recent proposition by Andrew Halpin seems to fill this gap.[26] According to Halpin, the distinction between different approaches to modelling constitutes a single key point for the interpretation, understanding and application of the Coase theorem. Accordingly two types of models should be distinguished. A direct model is a model that pertains to the existing world. In other worlds, any reference to methodological realism seems to refer to such a model. Direct modelling concentrates on the production of the most precise and accurate picture of our world.[27] This certainly means that a model sheds some light on the practices, processes and causal links exiting in reality.[28] Direct theorising could be explained as the search of the most accurate information about some processes, and as such, endorsing a positive description it additionally contains a secondary normative application. The proposal for improvement is thus based on the descriptive accurateness of a given direct model.[29]

Indirect modelling is different in this respect. An indirect model entails a set of optimal conditions under which the initial assumptions hold, even, if the existence of an underlying set of objects is impossible of fairly limited or otherwise the existence of such a world seems to be questionable. Lack of realism does not affect the soundness of a given indirect model. However, the model plays an important role, since it could be applied as a foundation for a purely normative benchmark.[30] Thus, the gap between the two models could be measured and the deficiencies of our real world could be overcome, if the conditions for the ideal world were met. It should be emphasized that the indirect model operates on a normative ground in a way, which is strikingly different from the direct model. The indirect model does not contain normative propositions. It seems as if the model was a description of the ideal world, whose essence coincides with the set of prescriptions. Some conditions of a given model could be met in our real world, transforming it in ex-post or reformed state of affairs, others can't.[31] Halpin claims that the distinction between the two ways of theorizing is essential for the application of the Coase theorem in the sense that the lack of it leads to confusion. Such a selective choice between different elements of the models inevitably leads to some oversimplification when it refers to the Coase theorem. A main line of criticism raised by A. Halpin against the accuracy of the Coase theorem concerns the lack of clear delimitation between direct and indirect worlds. It is especially discernible in case of conditions of the legal world; a world where the initial allocation of rights and liabilities is based on existing legal rules. It seems that the legal world should not only be described in

[26] Halpin, pp. 91–109.

[27] Halpin, p. 93.

[28] Halpin, p. 95.

[29] Halpin, p. 97.

[30] Halpin, p. 98.

[31] Halpin, p. 99.

terms of economic theory and reflected in direct model, but also to be transformed in accordance with the propositions supported by or derived from the normative prescriptions based on indirect modelling. This entanglement between direct and indirect models finally creates a very peculiar structure of discourse in law and economics, the structure reflecting the application of economic reasoning to legal concepts and their operation within legal world of positive transaction costs (legal PTC world). As Halpin observes:

> At the heart of Coase's influence on the Law and Economics movement is found a basic tenet about the relational priority between law and economics: economic calculations of efficiency can determine how the law does or should resolve a conflict between competing activities, but legal resolutions of conflict can not affect the relative economic values of competing activities. The greatest significance allowed to the law is to sustain inefficient allocations of resources when impediments to bargaining prevent the economically efficient allocation of resources. Even when this concession is made, it is less a reflection of the might of the law prevailing over economics and more a condemnation of the economically inefficient factors prevailing in society to which the law has misguidedly become attached.[32]

According to Halpin, this kind of confusion concerning the relationship between direct and indirect modelling is already present in Coase theorem and it characterizes a majority of law and economic theorizing, especially in the American Law and Economics scholarship. Moreover, Coase theorem seems to be inaccurate if it states that the lack of transaction costs in our world enables economic efficiency, endowment effect irrespectively. It seems that the assumption concerning lack of endowment effect or lack of distributive effects in our world of positive costs is misleading. It is misleading because the transformation of the PTC world into a ZTC world does not lead to the situation in which distributive effects are irrelevant. It is not my intention to discuss whether Halpin is correct with his interpretation of *The Problem of Social Cost.* I would only like to point out that his contention is based on the assumption on the interpretative nature of any model. It seems that this statement is correct since the classification of any model as direct or indirect, positive or negative is ultimately based on interpretation of the model at hand. The question arises where this omnipotence of interpretative strategies could lead us. In my opinion, it could lead to the need of the more accurate analysis of different jurisprudential claims concerning both, law and economics. It is precisely the difference between the direct and indirect models, which is reflected in two possible relationships between law and market. According to the first one, law seems to create some institutional environment for the existence of the market. This attitude is present in a positive variant of the Coase theorem, where Coase observes that even in a ZTC world, law sets foundations for the initial allocation of rights. In this claim Coase is wrong, since in the ZTC world, parties will always be able to establish an initial allocation.[33]

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[32] Halpin, p. 100.

[33] Cheung, p. 37. Coase admitted that he had been wrong about the foundational function of law: Coase, 'The Firm', p. 15.

The same confusion however could be found in the heart of analytical jurisprudence, namely in the work of H.L.A. Hart.[34] Hart rightly observes that it is possible to imagine a world in which it could be possible for a lawmaker to create gapless law.[35] He even goes further when he refers to the ideal legal world of complete law, saying that:

> If the world in which we live were characterized only by a finite number of features, and these together with all the modes in which they could combine were known to us, then provisions could be made in advance for every possibility. We could make rules, the application of which to particular cases never called for a further choice. Everything could be known something could be done and specified in advance by rule. This would be a world fit for "mechanical jurisprudence".[36]

It seems that a world of mechanical jurisprudence overlaps with the Coasean ZTC world. In such a world without transaction costs, the parties can anticipate any legal change and the lawmaker is able to produce complete law, because it costs nothing to create another legal rule. Yet both Hart and Coase admit that such a world is unreal. Hart plainly confesses that:

> Plainly this world is not our world; human legislators can have no such knowledge of all the possible combinations of circumstances which the future may bring.[37]

This only means that legal theory lacks an adequate direct model explaining how legal institutions and legal system really work, even if Hart's effort in jurisprudence could be understood as an attempt to produce a realistic description of the working of any legal system.

On the other hand, Hart does not take the potential of the metaphor into account, when he observes, that the very existence of law seems to be an effect of the "failure" of this idealised world, in which judges are redundant, there are no disputes, and every legal rule is absolutely clear. It is not that obvious whether this idealised world plays any important normative role till the concept of the *Rule of Law* is introduced and explained.

It is not my intention to analyse deficiencies of contemporary legal positivism. My claim is limited to a very simple conclusion. It seems that the confusion produced by the interrelationship between direct and indirect models is not limited to economics or law and economics and it also affects legal theory. If it is so, two potential strategies are possible. The first one builds upon assumption that law is touched by scarcity of resources and this brings economics into law. Some more realistic institutional models of the interconnections between law and its economic nature were produced according to this way of reasoning. Concurringly they may

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[34] Herbert L. A. Hart, *The Concept of Law*.

[35] Hart, pp. 128–129.

[36] Hart, p. 128.

[37] Hart, p. 128.

offer a better understanding of the interdisciplinary nature of law and economics. It seems that some of this kind of direct modelling plays an important role in economic analysis of law in Europe.

On the other hand, the indirect models play an important role in American jurisprudence, especially in the Law and Economics movement to the extent to which it has been shaped by methodological approach proposed by Gary Becker and Richard Posner.

4.3 *Homo Iuridicus* Within the European Law and Economics: The Coase Theorem Within a Light of Descriptive Institutional Theory

The original observations by Coase concerning the relationship between economics and law as well as various forms of market institutionalization led to the emergence of two major trends within the contemporary economics: economics of transactional costs and neoinstitutional economics. Moreover, Coase's observations were used as a foundation of one of the dominant movements in the American philosophy of law, namely economic analysis of law. Additionally those findings found their way to European legal scholarship as well.[38]

One topic is particularly spectacular in this respect, namely the relationship between the existence of law and the economic model of decision-making on the one hand and the institutional structure on the other. This relationship has been reflected in the interpretation of Coase theorem proposed in Europe by Antonio Nicita and Roberto Pardolesi. They discover a fundamental link between the two different albeit connected works by Ronald Coase, namely *The Nature of the Firm* from 1937 and *The Problem of Social Cost* from 1960. In both articles Coase demonstrated different aspects of incompleteness. Whereas *The Nature of the Firm* reflected the problem of incompleteness in contracts, *The Problem of Social Costs* supposedly pertained to the incomplete nature of property rights. Both problems were investigated from the perspective of classical economics, leading to some paradoxes as well as new insights. Firstly, Coase observed, that contractual incompleteness as a source of transaction costs leads to integration and transforms market-based contractual relationships into hierarchical structure of firm. Additionally, incompleteness or lack of well defined property rights leads to the situation in which either administration of courts have to resolve disputes and to fill in existing gaps. Thus judges in fact participate in lawmaking process specifying the content of rights through the resolution of particular conflicts. This kind of institutional analysis is based on clear direct model, referring to the features of existing institutional frameworks. It is obvious that Coase begins his exposition of

[38]Campbell and Klaes, pp. 567 et seqq.; Nicita and Pardolesi, pp. 3 et seqq.; Golecki, 'The Coase Theorem', pp. 215–218; Golecki, 'Bargaining', pp. 162–164; Mathis, pp. 53–69.

The Problem of Social Cost with notorious references to law: its function, existence and dynamics of legal change. This aspect of the so-called "Coase theorem" seems to be almost entirely neglected. However, direct modelling in context of Coase theorem has its short-comings. Some proponents of law economics follow Robert Cooter, Donald H. Regan and indeed Paul Samuelson in claiming that Coase theorem is neither true nor false.[39] The proposition according to which, under the assumption of zero transaction costs, the final allocation of resources will always be efficient, the initial allocation irrespectively could be true or false depending on whether the parties to the contract succeeded in securing a Pareto optimal transaction. If it happened or not, this would depend on many different characteristics such as: bargaining skill, the value of the asset, the utility function of players and so on.

It is generally pointed out by many authors that the success of bargaining process cannot be automatically taken for granted. If the Coasean bargaining takes place on the market (a weak version of Coase Theorem), then the theorem itself does not add much to the general equilibrium theorem, and as such it is meaningless, even if true. If, however, Coasean bargaining is supposed to take place under the assumption of bimonopoly, where both parties have no market alternatives, then the whole problem seems to me one of game theory rather than strictly economics. Concurringly, the Coase theorem seems to be too strong. As R. Cooter rightly observes, at this stage there is no ultimate proof of the Coase theorem that could be either true or false, depending on circumstances. It seems that Ronald Coase was unable to uphold this objection. Responding to Samuelson's argument according to which it is an empirical statement of fact that parties will not necessary end up on the contract curve in a situation having been analysed by Edgeworth, he contended that:

> [. . .] the existence of indeterminacy, as Edgeworth showed, does not of itself imply that the result is non optimal. [. . .] In any case, there is no reason to suppose that the degree of indeterminacy over the sharing of the gains would be greater than in negotiations over the rights to emit smoke than in transactions which economists are more accustomed to handle, such as the purchase of a house.[40]

Certainly, the difference between economists and Coase consists in the fact that they don't suggest the sale of a house to be Pareto efficient, whereas the Coase theorem does. If it is a matter of empirical facts whether parties reach agreement or not then some economists take the root of empirical analysis as the statement. Hoffman and Spitzer famously found out that the Coase theorem holds in 92 % of cases consisting of a two-person negotiation process.[41]

Meanwhile it seems that analytical solution of the bargaining problem in ZTC world is possible due to the advancement in game theory.[42] The problem of the

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[39] Samuelson, *Collected Papers*, Vol. 2, p. 1411, Vol. 3, pp. 35–36; Regan, pp. 427 et seqq.; Cooter, pp. 115–123.

[40] Coase, 'Notes', p. 163.

[41] Hoffman and Spitzer, p. 73.

[42] Golecki, 'Bargaining', pp. 164–167.

choice of the terms of contract may be presented as another non-cooperative game, namely Rubinstein's bargaining game.[43] In this game, both players are making proposals (offers and counter offers) until one of the offers is accepted. The factor of time in which the agreement is reached is taken into account, so that δ represents the amount of decrease for a party for each period of time. If A offers x, he retains the share 1-x. Additionally, the discount of time should be taken into account. In these circumstances, the counteroffer from B is more attractive for A than his next offer if it gives $(1-x)\delta$. The game illustrates the thesis that the outcome of the bargaining process diminishes in time ("the cake is shrinking"), so that the sooner one offer is accepted, the better. This game has a unique subgame-perfect equilibrium:

A offers B: $\delta/(1+\delta)$ and does not accept any counteroffer from B. B accepts any offer equal or greater than $\delta/(1+\delta)$ or makes a counteroffer of $(1-x)\delta$. A receives $1-x$ or $1/(1+\delta)$. The strategy of A is never to accept a counteroffer, taking into account that the B's counteroffer is not larger than $(1-x)\delta$. The best strategy for B is to take the initial offer. Thus, A makes the offer large enough so that B is not able to make a counteroffer preventing repetition of the same offer. The question arises whether such a game may have a unique efficient solution. If such a unique solution were attainable than it would correspond with terms of the hypothetical bargain. The problem of the division of the surplus would have been thus solved and the efficient outcome would have been assured as R. Coase admitted in *Notes on the Problem of Social Cost*:

> It is certainly true that we cannot rule out such an outcome if the parties are unable to agree on the terms of exchange, and it is therefore impossible to argue that two individuals negotiating an exchange *must* end up on the contract curve, even in a world of zero transaction costs in which the parties have, in effect, an eternity in which to bargain.[44]

It is important to note that if the players in Rubinstein's bargaining game had an eternity in which to bargain, then the game would have had very appealing characteristics. The model assumes that in a special case ($\tau \to 0$) where there is no time interval between the rejection of proposal and a new proposal and therefore it is virtually an advantage for the party who makes the offer first. There are no incentives to cheat in this game and no mechanism for sustaining commitments is required. Within time, the game converges to Nash bargaining solution. Additionally, the possible asymmetries between the parties result from different attitudes to the passage of time. In fact the interpretation of Rubinstein's bargaining game stresses that the more patient party has more bargaining power. The difference does not lie in the bargaining skill because both parties are rational optimizers. All those characteristics of the Rubinstein game are feasible under the assumption that bargaining is costless. If transaction costs are zero, the lapse of time between offer and counter-offer does not matter. As Coase has rightly observed, the peculiar feature of the zero transaction cost world is that:

[43] Rubinstein, pp. 97 et seqq.

[44] Coase, 'Notes', p. 161.

> when there are no costs of making transactions, it costs nothing to speed them up, so that eternity can be experienced in a split second.[45]

This means that the Coasian zero transaction cost world corresponds to the Rubinstein's bargaining game with no time interval between the rejection of proposal and a new proposal. Even if the Coase theorem was initially supposed to serve as a benchmark for Coasean critique of abstract methodology of neoclassical economics, it ultimately dissolves into the abstract thinking of game theory. The question remains: why was the proposition so vehemently defended by Coase himself? It seems that the function of the Coase theorem changed in time. Initially it could be implemented as heuristic device, whereas later on it also has been related to an unfinished project of a theory of regulation. In 1960, Coase treated the level of transaction cost as an exogenous factor, however, he did not do so in 1988. The later discussion on the theorem and its multifaceted nature lead to the foundations of the regulatory theory, which has been broadly presented in *The Firm, the Market and the Law*. According to Ronald Coase's later theory, the level of transaction costs was no longer exogenous, since the level of transaction costs seems to be variable depending on institutional and regulatory framework. As Coase realized, the funny ZTC world had mistakenly been taken as an artificial speculation of formal models applied by neoclassical economists. The opposite turned out to be true- ZTC worlds have been created within some sectors of economy, the stock exchange being the most obvious example. As Coase rightly observed:

> If the traditional markets of the past have diminished in importance, new markets have emerged in recent times of comparable importance in our modern economy. I refer to commodity exchanges and stock exchanges. [. . .] All exchanges regulate in great detail the activities of those who trade in these markets (the times at which transactions can be made, what can be traded, the responsibilities of the parties, the terms of settlement of disputes and impose sanctions against those who infringe the rules of the exchange. It is not without significance that these exchanges, often used by economists as examples of a perfect market and perfect competition, are markets in which transactions are highly regulated. It suggests, I think correctly, that for anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed.[46]

The ongoing evolution of institutional frameworks finally lead to substitution of transaction costs by costs of governance, proving the Coasean theory of firm expounded in article *The Nature of the Firm* from 1937.[47]

Moreover, Coase theorem seems to be open to many alternative interpretations. Traditionally the discussion pertaining to the Coase theorem rests upon the assumption that the theorem bridges the gap between the ZTC world and the PTC world. It is possible to build such a bridge in the form of the so called normative version of the Coase theorem, according to which in case of positive transaction costs the court of a lawmaker should take the economic consequences into account

[45] Coase, 'The Firm', p. 15.

[46] Coase, 'The Firm', pp. 8–9.

[47] Nicita and Pardolesi, pp. 34–38.

and ascribe the rule on liability or any rule which is supposed to establish an initial allocation of rights as if it were established by market. Alternatively the normative version of the Coase theorem could also be understood as if it required minimisation of transaction costs by judges and legislators. In my opinion it is difficult to interpret *The Problem of Social Cost* in that way. Actually it seems that the authentic Coasean version or anything resembling normative Coase theorem concentrates on the balance between legal certainty and economic efficiency. *The Problem of Social Cost* contains the following recommendation, which has not yet been analysed, at least to my knowledge:

> It would therefore seem desirable that the courts should understand the economic consequence of their decisions and should, insofar as this is possible without creating too much uncertainty about the legal position itself, take these consequences into account when making their decisions.[48]

Coase has demonstrated how this could be possible and at the same time how it could be difficult for courts to do, when he analysed an array of legal cases including: *Sturges v. Bridgemen* 1 Ch.D.852, *Cooke v. Forbes*, 5 L.R. Eq. 166 (1867–1868), *Bryant v. Lefever* 4 C.P.D 172 (1878–1879), *Bass v. Gregory*, 25 Q.B.D 481 (1890). Actually the major part of *The Problem of Social Coast* is devoted to close analysis of legal material, both common and statutory law on nuisance. The final conclusion of this section stipulates that legal doctrines operate on a substantially different basis than an economic one and it is possible to defend common law doctrines under the assumption of zero transaction costs. This conclusion is striking, since the question remains why people would bring disputes to courts under the assumption of zero transaction cost world? The question remains what Coase would like to demonstrate while closely scrutinising the above-mentioned jurisprudence of the English courts? It seems that the final proposition was aimed at normative statement or even a normative model of adjudication rather than mere critique of common law doctrines such as e.g. the doctrine of lost grant.

This context of Coase theorem is extremely important, and still it seems to be thoroughly neglected. Usually the commentators concentrate on the juxtaposition of ZTC and PTC worlds. At the same time they seem to be unaware of the additional juxtaposition Coase has endorsed in his article, namely the substantial difference between the world with complete legal rules and the world without it.[49] In a ZTC world the existence or lack of any rule ascribing liability for damage makes no difference from the perspective of efficiency – both parties would be able to secure transaction and the production will be maximised.

The question remains what would be the final effect of the existence of transaction cost for legal system rather than the economy. If transaction costs are high, parties will no longer be willing to agree on a given rule of liability. Moreover, the only possible solution for the conflict seems to be a judicial intervention in form

[48] Coase, 'Social Cost', p. 119.

[49] This point has also been raised by Halpin, pp. 101–104.

of judge made law. If positive transaction costs exist, it costs something to create a rule on liability whether in form of statutory law or contract law, and this will result with lacunas or gaps not only in contracts, but also in any form of legal rules and institutions.[50] To say the least- the artificial faith in the existence of the zero transaction cost world is not limited to neoclassical economists. It is rather shared by both economists and lawyers together.

The difference between Coasean and Pigouian assumptions concerns not only the scope of governmental intervention, but also the attitude to law and legal rights. For Arthur C. Pigou, the problem of externalities seemed to be simple just because of the fact, that it was not symmetrical or bilateral. It was unilateral in a sense that the damaging party was liable, and liability depended on the existence of right infringed by perpetrator. Pigou's approach was thus based upon assumption that on the one hand the market cannot effectively internalise damage caused by an externality, but on the other hand law is complete in such a case. Coase disagreed not only with Pigou's economics but also with his underlying jurisprudence; hence he obsessively emphasized the fact that the problem of social cost has a bilateral and symmetric nature. It can only have such a reciprocal nature under the assumption of legal incompleteness.

Whether A infringes B's right or the other way around seems to be unknown at that initial stage, as it is discernible only *ex post*, when the judgment of the court decisively resolves a dispute. The fact that reasonable parties litigate instead of contracting has a profound justification: both contracting and lawmaking seem to be tackled by the same problem of transaction costs- in both cases those costs could be plainly considered as costs of lawmaking. The source of both is in fact the same – it is a set of information and coordination costs. If such costs distort two persons bargaining it is quite understandable that they could be even higher in case of statutory lawmaking. Thus one of the most striking consequences of the Coase theorem is the contention that law seems to be inherently incomplete in a PTC world, whereas its' completeness in the form of a massive regulation coincide with the existence of ZTC environments such as the stock exchange.[51] Such a stock exchange does not need courts, and it is true that the cases in such areas of highly regulated transactions are virtually non-existing.

Thus, according to Coase, efficient allocation is possible only under the condition that the system of law contains a norm ascribing in a clear and rather permanent way tort liability in case of nuisance caused by one of parties. Coase theorem may be interpreted in such a manner as stating the advantages of certain and stable allocation of rights and obligations stemming from the positive law or judicial rulings (precedents). Such a situation enhances the allocative efficiency of resources. It seems that this interpretation is based on the explanation and development of the direct model in Halpin's term. At the same time it is coherent with Hart's observations regarding the incompleteness of law in the real world. Even if it

[50] It has been admitted by Coase, 'Notes', p. 178.

[51] Coase, 'The Firm', pp. 9–10.

contains some references to the indirect model, the prescriptions of economic theory seem to be coherent with legal theory containing clear delimitation between the direct model of the real world and the indirect model enhancing potential efficiency. It seems however, that such interpretation could be confronted with two serious arguments. Firstly, the economic analysis of law could be understood as predictive rather than an explanatory device, according to the methodological assumptions adopted by American Law and Economics. Secondly, the legitimacy of economic analysis of law could be perceived in pragmatic terms even by some European philosophers who deny the claim to there being any correspondence between reality and direct models.

4.4 *Homo Economicus* Within the American Law and Economics: The Coase Theorem and Predictive Theory of Human Behaviour

One may distinguish a special group of economists commenting on Coase theorem. The representatives of the first group assumed that in order to interpret Coase statements properly it is necessary to broaden the theory of rational choice and prize theory on extra market human behaviour. The most distinguished scholars of this movement were Gary Becker and Richard Posner.[52] In time, their interpretation of Coase theorem was transformed into a normative postulate of promoting such legal regulations, which were conducive to maximization of allocative efficiency. As Richard Posner observes:

> The analytical device of imagining the outcome of costless contracting is a legacy of Coase's famous article on social cost. [. . .] Coase's analysis sets two closely related tasks for law when law is conceived as a method of promoting efficient resource allocation: minimize transaction costs, as by defining property rights clearly and by assigning them to those persons likely to value them the most; try when transaction costs are prohibitive to bring about the allocation of resources that would have come about if transaction costs were zero, for that is the efficient allocation.[53]

Thus the notion of efficiency, which had not been openly explained by Coase himself, should be elaborated upon and constructed as a universal criterion for evaluation and critique of existing and proposed legal regulations. The interpretation proposed by R. Posner was later developed within the so-called Chicago school of economics. The three major assumptions of this movement may be summarized as follows. Firstly, individuals act according to the theory of rational choice, which was presented by J. von Neumann and O. Morgenstern in the book of 1944 *Theory*

[52] Becker, 'Crime', p. 169; Posner, 'The Decline', pp. 761 et seqq.; id., *The Economics*, pp. 205 et seqq.

[53] Posner, *Frontiers*, p. 41

of Games and Rational Behaviour.[54] The notion of rationality of players means that both of the actors aim at the maximization of their functions of utility. Moreover, the concept of rationality is based on the theory of revealed preferences based on subjective theory of values. Hence, moral norms are limited to hypothetical imperatives and should be linked to the actions of a player aiming to maximize their satisfaction. Therefore, the notion of rationality is a purely instrumental concept. It is connected to the effective realization of aims rather than to autonomous choice of those aims. According to this theory a given subject has permanent (invariable), ordered and non-transferrable preferences with regards to all possible states of things or actions.[55] Such a subject may be called *homo economicus*. This notion is not connected to behaviour of particular individuals but rather is used as a convenient tool for predicting future actions. Therefore, the concept of *homo economicus* is predicative rather than descriptive.[56] The only criterion of rationality used within this notion is connected to the existence of a limited coherence of preferences. Nevertheless, the process of their formation is basically outside the scope of the research of law and economics. According to R. Posner, the concept of *homo economicus* should not serve as a basis for explaining the mechanism of decision-making process, hence it is not a psychological theory but rather a model for predicting decisions which are to be made in the future. The primary aim of this notion is to introduce some order in existing relations rather than to describe or to explain them.

The second assumption of the Chicago school is connected to the choice of a proper criterion for the evaluation of actions aimed at the creation and application of law. The criterion for the proper critique of norms should be economic efficiency. According to R. Posner, the only useful criterion of allocative efficiency is the so-called Kaldor-Hicks efficiency.[57]

Thirdly, in economics of law it is assumed that individuals react in the same way in market and market external environments. Hence, sanctions that accompany legal norms are treated as a kind of cost, which has to be suffered in case of disobeying an obligation stemming from those norms. One may conclude that sanctions are treated in an analogous way to prices. The information contained in a legal norm is therefore, translated by individuals in order to enable them to rationally calculate the possible costs and benefits concerning prospective engagement in particular actions. The resulting preferences stem from the process of observation of the choices made by individuals.[58]

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[54]The detailed analysis of the notions of rationality and utility within the theory of Neumann-Morgenstern may be found in Załuski, pp. 42–71.

[55]Becker, 'The Economic', p. 14.

[56]Posner, *Economic Analysis*, pp. 15 et seqq.

[57]Posner, *The Problems*, pp. 374–387.

[58]This assumption was later confirmed by the broadly accepted within the contemporary economics theory of revealed preferences, presented by Samuelson, 'A Note', pp. 61 et seqq. and id.,

The three above-presented assumptions are mutually connected. Therefore, the acceptance of the theory of rational choice, which is commonly used within the neoclassical economics, implies the acceptance of a particular theory of instrumental rationality and specific conditions for this type of rationality to occur. Those conditions may be divided into two broad categories: external and internal ones.

The external conditions are connected with the necessary information for various alternative actions. On the assumption that the subjects of the law tend to maximize their satisfaction, which may be also termed as the maximization of the utility function, one may state that for a rational choice to be made it is necessary to evaluate various options and put them into order from the most to least preferred. Within the context of law, information, which enables one to make rational instrumental choices, is the category of a sanction measured in regard to utility function or measured in monetary units as a cost in economic terms.

The internal condition may be described as an ability of acting subjects for the exact measurement of costs and losses as well as the ability for initializing actions which are effective from Kaldor-Hicks criterion, i.e. which benefits are more significant than costs. One may ask about the method for making rational decisions, which maximize satisfaction, without the full access to information on the possible costs and benefits? According to R. Posner, rational action may be done, and in reality most often is done, in a state of uncertainty and ignorance, as the cost of access to full and excessive information is too high and hence ineffective.[59]

The above assumption seems to be based on a paradox. The rational action should not solely be subjected to the principle of knowledge, which is used as a basis for evaluating the consequences of actions, but rather should be performed according to the effectiveness criterion within the cost-benefit analysis. This paradox is not a real one when one assumes that the principle of effectiveness (wealth maximization) is a normative principle. Hence, according to R. Posner, it is possible to accept the epistemic limits of a subject without abandoning the theory of economic rationality. The latter is only subject to certain modifications.[60]

The theory of rational choice does not aim give a precise description of the method of decision-making. R. Posner uses similar methodological assumptions as M. Friedman according to which the theory of rational choice serves as a convenient tool for predicting various actions or processes.[61] Thus, the theory is to serve prescriptive purposes rather than descriptive ones.

'Consumption', pp. 243 et seqq. Nevertheless, the theory has met with the criticism of some scholars. See Sen, pp. 307 et seqq.

[59]Posner, *Economic Analysis*, p. 19.

[60]Posner, *Economic Analysis*, p. 19, where he states that: "[. . .] People are not omniscient, but incompletely informed decisions are rational when the cost of acquiring more information exceed the likely benefits in being able to make a better decision. A fully informed decision in such circumstances – the sort of thing a person makes who cannot prioritize his tasks – would be irrational."

[61]Friedman, p. 14.

The programme of the Chicago school has been the foundation for further development of various detailed theories on law and economic efficiency as well as the analysis of legal norms with the use of economic criteria like Kaldor-Hick's and wealth-maximization. The legitimacy of the law and economics scholarship is no longer based on its utilitarian origins. Moreover, the majority of ideological and moral propositions could at the same time possibly be attacked and defended on the level of law and economics as it in fact happens. The most characteristic feature of this kind of discourse is heavily dependent on the linguistics constraints commonly accepted among law and economics scholars. My main thesis thus pertains to the distinctive features of the law and economics models as compared to typical jurisprudential narratives. The key distinction to be implemented in this respect is the difference between the narrative and the model. The narrative is being developed and treated as a kind of linguistic game in Wittgensteinian sense, whereas the model is being treated as the simplified representative of the interrelations between the objects. The narrative deploys some metaphors, whereas the model can never be based on the metaphor simply because of the fact that the model is supposed to contain the direct representation of the given aspect of the object and this representation of the modelled object must be univocal. The narrative is supposed to be overwhelming and thus satisfies the need for the ultimate answer to the given set of questions, such as those regarding the nature of law, the essence of rights, the character of justice, whereas from the perspective of the law and economics discourse those questions are sense-less in a strong sense, i.e. they cannot be addressed and answered according to the adopted verification procedure.

The former is built upon philosophical concepts as created by some philosophical systems and later on transformed into narrations. The latter seems to be rather functional and purpose oriented. The question remains however about the relationship between the two. It is obvious that the philosophical concept-oriented discourse instructs different approaches and models within the law and economics mainstream. Thus, some indirect interdependence between direct and indirect models within economic jurisprudence is undeniable. Moreover it seems that economic models borrow from the traditional legal vocabulary. It is, however, not clear to what extent the content or substance of those philosophical-narrations involved concepts such as: "distributional justice", "equity", "rights", "liberties", "entitlements", "fairness", etc. influences the outcome of the modelling procedure accepted in law and economics. The *prima facie* observation is that those concepts, at least to some extent, shape the formulation of the basic assumptions accepted within a given model. Economic modelling is always "assumption sensitive". One may ask whether the basic assumptions of the economic analysis of law, like the economic rationality or efficiency, should be subject to critical examination. It may be stated that the overall perception of the economic analysis of law places this theory within the typical modernist, rational and utilitarian conceptions of law. One may state that this is the point where *homo economicus* meets *homo iuridicus*. Both models are based upon the assumption of a particular theory of human behaviour within the economic or legal sphere. This behaviour is part of a process geared towards the accomplishment of particular aims, avoiding costs and maximizing a

given type of satisfaction from the other side. Moreover, subjectivity is placed within the sphere of decision-making and under the constraints of instrumental rationality, both in economic and legal activities. The pursuit for maximization becomes an autonomous research topic within the economic studies. The contemporary theory of rational choice may be successfully used for the analysis of market and non-market behaviour, and in particular those actions concerning law. Thereby, justifying that the economics law is based upon is the criterion of efficiency, in accordance with the Friedman's paradigm of economic sciences.[62] Moreover, the urge of the economics of law to operate with expert knowledge makes the dialectics of consciousness and unconsciousness less visible. As Richard Posner states, rationality within the theory of rational choice is only a function of the predictive purpose of the very same theory.[63] The process of sustaining order within the world with the use of expert knowledge tends to accumulate the growth of expertise and simultaneously the power of experts.

4.5 Conclusion

The comparison between the two competitive frameworks of law and economics, the direct model-based and the indirect model-based discourses, leads to two preliminary remarks. Firstly, the direct models are general and their legitimacy is founded on their integrity whereas the indirect model-based discourses are partial as they do not claim integrity and their legitimacy is founded on their utility. Secondly, the two different discourses are legitimized in strikingly different ways. The traditional descriptive discourse of direct models derives its legitimacy from the completeness, coherence and general plausibility of the conceptual structure. The indirect model-based discourses are founded on the coherence between the assumptions, the conclusions and the control on a given object. In other words, indirect models are legitimized by their usage and the effect of their predictive functions rather than the descriptive ones. It seems that R. Coase was fully aware of the tension, existing within classical economics, between the sphere of imagination (idea of a perfectly concurrent market) and the sphere of reality (the market with all its weaknesses). Therefore, it is correct to conclude that the original intention of Coase had been to deconstruct the idea of a perfect market and to replace it with the research programme oriented towards the exploration of the real structure of the market through the examination of its institutional framework. It seems to be paradoxical that this kind of research is becoming more popular in Europe than in the United States, where it is largely accepted that particular features of the economic language concern its instrumental, predictive and finally normative rather than merely descriptive functions.

[62] In general terms, justification of sciences with the criterion of efficiency, has been stressed in the works of Lyotard.

[63] Posner, *The Problems*, pp. 25–85.

In reality, the apparent prescriptions and descriptions of both economic processes and human behaviour are strongly purpose oriented. They enable the prediction of future states of affairs provided they are based on a deep understanding of the causal links. Thus, the causal links reflected in the direct models play an important role in economic thinking despite their quite precarious nature. The already established connections between causes and results are resultingly of defaeasible or provisional nature. This, however, does not necessarily mean that the language of law and economics should be based on a kind of reductionism, which has to be purposive in a sense that it enables the prediction and effective control over the underlying processes.

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Chapter 5
Three Realistic Strategies for Explaining and Predicting Judicial Decisions

Diego Moreno-Cruz

I have the simplest of tastes. I am always satisfied with the best.

Oscar Wilde

Abstract This essay presents three strategies used to explain and predict judicial decisions. These include: (1) the economic approach, (2) the psychological approach, and (3) the naturalistic approach. The first two of these are teleological explanations or rationalizations while the third strategy is a mechanical explanation or natural causation approach. The mentioned strategies are then compared. The strategies differ in two aspects: (1) they are based on different assumptions and (2) they are based on different theories. They are, however, compatible in four different aspects which also characterize American Legal Realism. These are: (1) causal explanation, (2) ontological and epistemological beliefs, (3) predictive-theoretical objectives and products, and (4) the personality of the judge as the determinant of the judicial decision. According to Brian Leiter, one must choose between either the psychological approach and/or the naturalistic strategy but reject the economic approach. To make this choice, one must; (a) prefer the psychological approach to the economic approach, and (b) prefer the naturalistic approach to the economic approach. An epistemological pragmatic decision, to reject or prefer one approach over the other must be based on the evidence regarding the predictive failures and successes. Failing the availability of such evidence, it is acceptable to recognize all three approaches as realistic, complementary, different, available, and useful strategies.

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5.1 Introduction

Humans make predictions every day. We believe the future will be very similar to what we have perceived, remembered and learned from the past of our individual experience of life.[1] Most of the time our reasoning is inductive: from the observed (evidence) we infer the unobserved (prediction). This reasoning is uncertain and ampliative: uncertain in the sense that from the truth of the premises (evidence) there does not necessarily follow, only contingently, the truth of the conclusion (prediction); and it is ampliative in the sense that from certain information (i.e. evidence, information about the observed) we obtain additional information (i.e. prediction, information about the unobserved), that is, information beyond the available data.[2]

Causation (thinking in terms of cause and effect) is a type of inductive reasoning we use to explain and predict (sequences of) events.[3] According to Hume, causality is a habit of the mind of people, in their daily life, which has no deductive justification.[4] Notwithstanding the absence of justification, causal explanation of events (e.g. actions) is used by (at least) three different explanatory-predictive strategies concerning judicial decision-making.[5] These strategies will be considered here as different ways of systematizing (or approaching) the common-sense explanations and predictions made by lawyers about judicial decisions[6]: (i) the

[1]With individual experience I refer to the fact that human experience is "limited and fragmentary, for we each perceive only a little of the world, as it now is, and remember only a fraction of the world as it once was", Blackburn, p. 1.

[2]The denomination of the "ampliative" feature of inductive inference is from Charles S. Peirce. Cf. Giovanni Tuzet, *La prima inferenza. L'abduzione di C.S. Peirce fra scienza e diritto*; see also Jonathan L. Cohen, p. 5.

[3]On what we mean when we say that the "*x* sequence was causal, but *y* sequence was not", see Mackie, pp. 29–58.

[4]Hume, pp. 134 et seqq.: "[. . .] the supposition, *that the future resembles the past*, is not founded on arguments of any kind, but is deriv'd entirely from habit, by which we are determin'd to expect for the future the same train of objects, to which we have been accustome'd."; on this supposition see Rhees, pp. 73–77. On Hume's concept of causation see Quine, pp. 156–198: "I do not see what we are further along today than where Hume left us. The Humean predicament is the human predicament."

[5]Here, I limit myself to a generic application of the three strategies, i.e. I apply them to the decisions in general and therefore to the judge decisions in particular. This does not mean that judicial decisions do not have specificities respect to decisions in general. But here it is not my interest to expose such specificities.

[6]Like Holmes, pp. 457 et seq., suggests: "Far the most important and pretty nearly the whole meaning of every new effort of legal thought is to make these prophecies more precise, and to generalize them into thoroughly connected system." That the theoretical discourse about judicial decision of American Legal Realism had been oriented to lawyers, see Brian Leiter, *Naturalizing Jurisprudence. Essays on American Legal Realism and Naturalism in Legal Philosophy*; id., 'Holmes, Economics, and Classical Realism'.

economic approach (economic analysis of law, EAL[7]); (ii) the psychological approach (psycho-cognitive theory); and (iii) the naturalistic approach (Naturalized Jurisprudence, NJ).

The kind of causal explanation offered by the economic and the psychological approaches is a *teleological explanation* or *rationalization*[8] (normative, in the former, and descriptive, in the latter[9]): explanation of actions through *reasons*; reasons are considered to be the determinants of, or serve to explain, individual actions. On the other hand, the kind of explanation offered by the naturalistic approach is a *mechanical explanation* or natural causation: explanation of actions through *facts*; facts are considered to be the determinants of, or serve to explain, individual actions.

In Sect. 5.2, I will compare the three strategies above and highlight the peculiarities of each of them; in Sect. 5.3, I will present Brian Leiter's basic epistemological option: opting for the psychological or naturalistic strategy and rejecting the economic one to explain and predict judicial decisions. I will argue, from a pragmatic point of view, that is, precisely, the one that Leiter seems to accept, that such epistemological option is ill founded. In Sect. 5.4, I will offer some concluding remarks.

5.2 Differences and Compatibilities

The three approaches – economic, psychological and naturalistic – to judicial decision-making are different but compatible in several aspects.

5.2.1 Different Aspects

The three approaches differ in at least the following two ways.

Different Assumptions

1. **The Homo Economicus**. To explain observed events and to predict unobserved events, the economic approach uses, *inter alia*, the basic assumption of the rational decision theory (RDT) according to which people (e.g. judges) make

[7]I will mainly pay attention to Richard Posner's work (only as an example of one author, among others, that applies rational decision theory for analysing law).

[8]About rationalization as a kind of causal explanation, cf. Davidson, 'Actions, Reasons, Causes', pp. 3–21.

[9]See *infra* Sect. "Different Strategies and Kind of Explanations for Various Theories".

decisions as if they were "rational agents". The rational agent (judge) aims to maximize (expected) utility and is endowed with the necessary ability and knowledge to reach this purpose by his or her decision. The term "rationality" from the economic point of view denotes "the ability and inclination to use instrumental reasoning to get on in life".[10] In this sense, for the RDT rationality, broadly speaking, is "choosing the best means to the chooser's ends".[11] Hence, RDT accepts the assumption that agents are provided with instrumental rationality.

The image of homo economicus is an essential element of the economic hypotheses, which are considered useful if they find a "meaningful empirical counterpart", that is, if their assumptions and implications are useful in explaining specific cases.[12] The economic approach believes that describing decision-making is not necessary to obtain successful predictions. It also recognizes that its main assumption of the rational agent is psychologically unrealistic, but despite this, it is useful for making predictions.[13] Indeed, according to this approach, the greater the ability of a theory to describe, the lower is its predictive power.[14]

The purpose of economic hypotheses is to identify patterns of regular behaviour of people (e.g. judges) in the (judicial) decision-making process. These hypotheses are generalizations, which help to predict decisions (e.g. judicial decision) in similar situations to the case at hand.

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[10]Posner, *Economic Analysis*, p. 3: "[Rationality] does not assume consciousness (rational decisions are often intuitive). It certainly does not assume omniscience; positive information costs are assumed [. . .] (They are of two kinds – costs of acquiring information and costs of processing and using information intelligently)."

[11]Posner, 'Rational Choice', p. 1551.

[12]Friedman, pp. 4 et seq.

[13]Friedman, pp. 25 et seq.: "[Economic theory] is a body of tentatively accepted generalizations about economic phenomena that can be used to predict the consequences of changes in circumstances." A theory that is totally unrealistic "is clearly unattainable, and the question whether a theory is realistic 'enough' can be settled only by seeing whether it yields predictions that are good enough for the purpose in hand or that are better than predictions from alternative theories. Yet the belief that a theory can be tested by the realism of its assumptions independently of the accuracy of its predictions is widespread and the source of much of the perennial criticism of economic theory as unrealistic."

[14]Friedman, pp. 4 et seq.: "Truly important and significant hypotheses will be found to have 'assumptions' that are wildly inaccurate descriptive representations of reality, and, in general, the more significant the theory, the more unrealistic the assumptions." See also Posner, 'Rational Choice', p. 1559: "[. . .] in theory-making, descriptive accuracy is purchased at a price, the price being loss of predictive power." See also Posner, 'Institutional Economics', p. 128: "[. . .] the purpose of theory, which is not to describe the phenomena being investigated but to add to our useful knowledge, mainly of causal relations. For that purposes an unrealistic theory may be quite serviceable – may in fact be serviceable."

Starting from assumptions (which are psychologically unrealistic) and exclusions or restrictions (e.g. sunk costs are not relevant to making current decisions[15]), EAL first justifies, and secondly explains, the decision-making of actors (e.g. judges) as rational agents.[16]

This view positions the homo economicus or the "rational agent" image which (1) has a total order of – transitive, asymmetric, independent and consistent – preferences[17]; (2) acts strategically: i.e. he or she is provided with instrumental rationality – meaning that the agent seeks the best and most effective way to make a decision that is rational, i.e. choosing the best alternative choice based on available information (i.e. alternative actions, possible outcomes and states of the world)[18]; (3) a rational maximizer, which means he or she responds to incentives: the agent alters his or her behaviour if by doing so he or she increases his or her utility (happiness, pleasure, satisfaction)[19]; (4) acts on his or her own interest, which is different from acting selfishly, since the happiness (or unhappiness) of the other "may be part of one's satisfactions"[20]: i.e. it is self-interest and not other-interest,[21] and (5) adapts his or her decision to the axioms of the expected utility (sub)theory (EUT), which is the standard of rationality in the RDT, in decision problems under risk, i.e., when decisions concern *risky* alternative outcomes.

EUT is based on the unrealistic assumption of a rational agent who has knowledge of relevant aspects of his or her context; has the ability to organize, in a "rational" way, a complete and static system of preferences; and has the ability to calculate which of the available courses of action allows him or her to achieve the

[15]Posner, *Economic Analysis*, p. 7, note 10: about "sunk costs" Posner says that rational people base their decisions on expectations about the future, not complaints or regrets about the past: "[. . .] it is not the emotion of regret that is irrational, but acting on the emotion rather than letting bygones be bygones. Regret is a form of self-evaluation and is valuable in improving future conduct ('I won't do this again because I know I would regret it')."

[16]Like has been explained *supra*, EAL is based on rational decision theory (RDT). This theory "is first of all normative, and only secondarily explanatory". See Elster, p. 14.

[17]*Completeness*: for every two alternatives x and y the agent may prefer x over y, or y over x or x and y are indifferent alternatives for the agent; *transitivity*: if the agent prefers x over y and y over z, then the agent prefers x to z; *Asymmetry*: if the agent prefers x over y, she or he cannot prefer y over x; *Independence*: if the agent prefers x over y, this order of preference does not change if an event occurs that presents a new alternative z; *Consistency*: if the agent prefers x over y, the agent prefers the probability that x will happen over the probability that y will happen, see Schäfer and Ott, p. 52.

[18]Bermudez, pp. 2 et seq., 13.

[19]Posner, *Economic Analysis*, pp. 4 et seq., 7–9: from the assumption that the rational agent responds to incentives there derive the three laws of economics: the law of demand, the law of opportunity costs and the law that resources tend to gravitate to the most valued use (provided voluntary transaction is allowed).

[20]Posner, *Economic Analysis*, p. 3.

[21]Bishop, p. 217.

result with the highest value (or utility) of his or her ordinal and invariable scale of preferences.[22]

2. **The Homo Psichologicus**. To explain observed events and to predict unobserved events, this approach describes how people (e.g. judges) decide under hypothetical decision-making scenarios. Based on this description, it explains the decision-making of the agent and identifies effects (e.g. certainty, reflection etc.[23]) and motivational reasons (in a subjective sense, opposed to external reasons[24]) that are determinants of the decision, and are ignored by the RDT. The description and explanation of decision-making, in turn, allows one to identify generalized patterns of behaviour of individuals (e.g. judges) in the decision-making process of (judicial) decisions. Predictions about future decisions are based on these generalizations.

In a seminal paper, the economist Herbert Simon[25] proposes a more realistic psychological profile than the one assumed by traditional economic (or Neoclassical) thought. For Simon, humans are organisms with limited knowledge and capacity. People do not really apply EUT to making decisions. Humans most of the time make decisions that do not maximize their expected utility, but simply are *good enough*, according to the adjustable or dynamic level of their aspirations. This level defines a satisfactory alternative for the attainment of their objectives:

> The aspiration level, which defines a satisfactory alternative, may change from point to point in this sequence of trials. A vague principle would be that as the individual, in his exploration of alternatives, finds it easy to discover satisfactory alternatives, his aspiration level rises; as he finds it difficult to discover satisfactory alternatives, his aspiration level falls [...] we are interested in models of "limited" rationality rather than models of relatively "global" rationality [...] This, I submit, is the kind of rational adjustment that humans find "good enough" and are capable of exercising in a wide range of practical circumstances.[26]

For this approach, contrary to the economic approach, the psychological description of the decision maker is a necessary step prior to the explanation and prediction of the decision-making process. Thus, it is important to use assumptions that are psychologically descriptive and, hence, models of bounded rationality. Simon also suggests that people's behaviour often respond to factors other than the reasons of maximizing profit and self-interest. In this sense, Simon adds that emotion (which is ignored by the traditional economic way of thinking) is a determinant factor in the decision-making process:

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[22] Simon, 'Behavioral Model', p. 99.

[23] Kahneman and Tversky, 'Prospect Theory', pp. 263–292.

[24] On external (normative)/internal (motivational) reasons see O'Connor, pp. 129–138; see also Williams, pp. 101–113.

[25] Simon, 'Behavioral Model', pp. 99–118.

[26] Simon, 'Behavioral Model', pp. 111, 113, 118.

> One thing an emotion can do for and to you is to distract you from your current focus of thought, and to call your attention to something else that presumably needs attention right now [. . .] A behavioral theory of rationality, with its concern for the focus of attention as a major determinant of choice, does not dissociate emotion from human thought, nor does it in any respect underestimate the powerful effects of emotion in setting the agenda for human problem solving.[27]

In addition, the psychological approach considers that paying attention to the limited capacity and limited knowledge of human beings allows one to make predictions, about (judicial) decision-making, that are more reliable and accurate compared with predictions made by the economic approach.[28] This view postulates the assumption of the "psychological human being" whose ability and knowledge is limited in three aspects: (i) bounded rationality, (ii) limited power of will and (iii) limited self-interest or self-regard.[29]

3. **The Homo Naturalis**. To explain observed events and predict unobserved events, the naturalistic approach describes the judicial decision process and identifies the psychosocial facts that determine such decision. The product of this description is evidence, which in turn is used to identify patterns of regular behaviour of judges in the judicial decision-making process. Based on the identification of such patterns, generalizations are made that can be used to predict future judicial decisions: "[. . .] naturalistic explanations that make no reference to reasons, but only to relevant psycho-social facts about judges, represent the more fruitful way to go."[30]

Moreover, for this approach, contrary to the economic approach and in tune with the psycho-cognitive approach, the description of the decision-making process is a necessary step prior to the explanation and prediction of decisions. It is therefore important to use assumptions that are psychologically realistic:

> [Human beings] are essentially gullible, naive, and perhaps even foolish; and they are easily manipulated [. . .] are largely self-serving in their behavior yet are prone to irrational behavior and are simple-minded, easily fooled, and susceptible to being controlled and used [. . .] cannot be expected to do particularly well in satisfying even their perceived self-interest [. . .] the capacity for autonomous choice is largely beyond the reach of creatures like us, or at least the vast majority of us.[31]

In addition, for this approach, as for the psychological one, the explanatory strategy of the economic approach is inadequate because people (e.g. judges) do not actually make (judicial) decisions as is assumed by the RDT.[32]

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[27] Simon, 'Alternative Visions', pp. 199, 204.

[28] See Jolls, Sunstein and Thaler, pp. 1471–1550; see also Kahneman, pp. 162–168.

[29] On these three limitations see Jolls, Sunstein and Thaler, pp. 1471–1550.

[30] Leiter, *Naturalizing*, p. 43.

[31] Leiter, 'Holmes', pp. 288 et seq.

[32] Leiter, *Naturalizing*, p. 102: "Note that the question is not whether economists produce predictions – all of us, applying common sense psychology, make testable predictions about behavior all the time – but whether economics yields predictions of scientific quality, in terms of

Different Strategies and Kind of Explanations for Various Theories

Taking into account the differences between the three approaches to judicial decision-making, it can be said that each of these strategies are associated with three different theories.

1. **Rational Decision Theory: Normative Rationalization**. Associated with the economic strategy, there is a *normative theory of rational decision-making* (RDT and UET) whose generalizations follow: from the characterization of the psychological profile of the agent (i.e. his or her presumptive intentions that are composed by presumptive wants and beliefs, i.e. presumptive "primary reasons"[33]) to the decision that is the subject to be explained.

In other words, the kind of explanation offered by the economic approach is *normative* rationalization, i.e. explaining the judicial decision-making by reasons (e.g. efficiency in Kaldor-Hicks terms) that are assumed to be accepted by the agent, and then, work as the cause of agent's decision. The statements produced by this view are normative explanatory ones that are based on anankastic statements,[34] and they are technical "advice" of instrumental means-to-an-end rationality with a world-to-word direction of fit. The direction of fit (↑) of these statements suggests that the decision-making has to adapt to the explanation associated with the economic approach, so that the agent maximizes its (expected) utility.[35]

Under EUT people evaluate alternative courses of action based on the utility of the outcomes they are expected to produce, i.e. the utility of the final states of wealth.[36] The EUT assumes that the mental process of the agent comprises: (i) identifying a set of exclusive and jointly exhaustive outcomes; (ii) the allocation to each outcome or possible world of an estimate that corresponds to a probability function or value (i.e. measuring the agent's subjective belief) that this result occurs or this world is the actual world,[37] (iii) the allocation to each outcome or possible world of an estimate that corresponds to a utility function (or value) or degree (i.e. measuring the desire) of satisfaction produced by the fact that this result occurs or that this world is the actual world,[38] (iv) the calculation of the utility or expected value of all possible outcomes of the action under evaluation, (v) the estimation

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their precision and reliability. It is well known to everyone but economists, it seems, that economics does not: hence the omnipresent boundary conditions in economic predictions (i.e. the 'ceteris paribus' clauses) and the failure to make any real progress in the last 100 years in specifying the causally relevant parameters of the boundary conditions." See also Leiter, 'Holmes', pp. 302 et seqq.

[33]Davidson, 'Actions, Reasons, Causes', pp. 13 et seq.

[34]von Wright, pp. 10 et seq., 103 et seqq.

[35]I borrow from Searle the directions of fit distinction and its correspondent symbolization, Searle, pp. 12, 27–30.

[36]The first proposal of EUT is by Bernoulli, pp. 23–36.

[37]Lewis, p. 236.

[38]Lewis, p. 236.

of the utility and likely outcomes that are achieved efficiently by the agent, i.e. the agent has the ability to make the best use of the information available, (vi) the occurrence of unanticipated events (i.e. new information) does not alter the initial decision made by the agent on what course of action to take (i.e. rational expectations).[39]

2. **Psycho-Cognitive Theory: Descriptive Rationalization**. Associated to the psychological strategy, there is a decision-making theory of cognitive rationality whose generalizations follow: from the description of the decision-making process to the mental profile of the agent (i.e. his or her actual intentions, which are composed by actual wants and beliefs, and his or her emotions). In other words, the kind of explanation offered by the psychological approach is *descriptive* rationalization, i.e. explaining the decision by means of reasons that are identified from the description of the decision-making under hypothetical scenarios. The statements produced by this view are descriptive-theoretical-explanatory with a word-to-world direction of fit. The direction of fit (↓) of these statements suggests that the explanation should adapt to the decision-making process described.

Psycho-cognitive theory uses hypothetical decision problems to show that the decisions made by people systematically violate the key assumptions or axioms of the EUT. Such theory offers evidence of the inability of the EUT to describe the decision-making process under risk. An alternative model to EUT is proposed, called prospect theory (PT), which aims to describe how people make decisions on hypothetical scenarios that include risky alternatives. From the description of these decision-making problems, a series of effects that can be generalized are identified based on their repeated validation in further experiments.

PT assumes the mental process of the agent to be more complex than postulated by the EUT. People make second-order decisions[40] (decision-process, i.e. organization and processing of available information) to make first-order decisions (decision-product, i.e. the decision that is the object of explanation and prediction). In the organization of information, people make use of heuristics that reduce the complexity of assessing probabilities and predicting values, but sometimes produce errors and biases.[41]

PT takes into account an initial reference point (i.e. status quo) to describe the decision-making process of agents. Unlike EUT, this theory does not assign the value function (or utility) to the final outcomes. Under PT people value the results of an action based on "the magnitude of the change" (positive, i.e. gains; negative, i.e. losses) relative to a neutral initial reference point (i.e. status quo). In other words, for the PT value function (i.e. utility) is based on changes in wealth or welfare

[39] Noll and Krier, p. 327.

[40] Sunstein and Ullmann-Margalit, pp. 187–208.

[41] On judgments under uncertainty see Kahneman and Tversky, 'Judgment under Uncertainty', pp. 1124–1131. See also Kahneman and Tversky, 'Subjective Probability', pp. 32–47.

and not, as in the EUT, on final states of wealth or welfare. This assumption is compatible with the basic principles of perception and judgment – and seems to take into account Simon's adjustable aspiration level outlined above:

> Our perceptual apparatus is attuned to the evaluation of changes or differences rather than to evaluation of absolute magnitudes. When we respond to attributes such as brightness, loudness, or temperature, the past and present context of experience defines an adaptation level, or reference point, and stimuli are perceived in relation to this reference point.[42]

PT also describes how the agents evaluate risky results. Unlike EUT, PT does not deal with probabilities but with a weight function π that reflects the impact of the probability in the total value of the prospect. The weight function (or weight value) measures the magnitude of the deviation or change from one possible outcome relative to the initial neutral reference point. This weight function (which measures the magnitude of change) projects the probability but does not match with it: accordingly with PT people do not evaluate the results based on probabilities. People are not accurate in estimating the probability and the weight that people assign to outcomes, and do not match with the estimation of probability assigned to them. Most of the time, this weight is greater than the probability, except in cases where the probability is low.[43]

3. **Naturalistic Approach: Mechanical Explanation**. Associated with the naturalistic approach, there is a naturalistic judicial decision theory whose generalizations (in spite of having the same direction as the psychological point of view) follow: from the description of the decision of the agent to the identification of the *natural profile* of the judge that determine the judicial decision that is the focus of the explanation. The kind of explanation offered by the naturalistic approach is *natural causation or mechanical explanation*, i.e. explaining the decision of the judges by means of causes that are not reasons (i.e. they are psychosocial facts, different from the psychological fact of acceptance of a reason by the judge and, then, different from his or her intentions).

In other words, the statements produced by this view are descriptive-theoretical-explanatory ones that have a word-to-world direction of fit. The direction of fit (↓) of these statements suggests that, just as with the psychological approach, the explanation adapts to the decision process being described.

The determinants or causes that are not reasons (i.e. facts) make reference to political affiliations, demographic backgrounds, professional experience, social

[42] Kahneman and Tversky, 'Prospect Theory', p. 277.

[43] Kahneman and Tversky, 'Prospect Theory', pp. 263, 280: "Decision weights are inferred from choices between prospects much as subjective probabilities are inferred from preferences in the Ramsey-Savage approach. However, decision weights are not probabilities: they do not obey the probability axioms and they should not be interpreted as measures of degree or belief [. . .] Decision weights measure the impact of events on the desirability of prospects, and not merely the perceived likelihood of these events."

influences, sex, race, etc., of the judge.[44] This approach finds value in the studies of political science, which explain how ideology or political affiliation affects the judge's decision.[45]

One unique aspect of the naturalistic approach is that it considers that if you cannot find "sufficient reasons", it is impossible to rationalize the judicial decision. Therefore, for this view, the legal and/or extra-legal *reasons* are not sufficient causes to explain judicial decisions. It is necessary, then, to identify different causal factors, namely, causes that are not reasons.[46] So if the reasons do not justify an event (e.g. an action), then the reasons are not a sufficient cause of this event (e.g. the action that consists in judicial decision-making): "When legal reasons do not justify only one outcome, then other psychological and sociological factors (e.g. the personality or the political ideology of the judge) must come into play to causally determine the decision".[47] In short, this approach seeks to explain judicial decisions through psychological or social facts about the judge.[48]

5.2.2 Compatibilities: Three Realistic Approaches

The three approaches to judicial decision-making are compatible in at least four aspects that characterize the theory of adjudication of "American Legal Realism".[49]

1. **Causal Explanation**. It could be said that the economic and psychological views – following the arguments that Donald Davidson makes to justify the (common-sense) thesis by which rationalization is a type of causal explanation[50] – distinguish between two types of explanation, i.e. legal rationalization and extra-legal rationalization. These two types of rationalization connect reasons (legal and extra-legal class, i.e. factors that are offered in the *explanans*) with actions (e.g. judicial decisions-making to be explained, i.e. the *explanandum*).

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[44] Cf. Miles and Sunstein, p. 835.

[45] However, Leiter (for whom the naturalistic strategy is the most fruitful way to explain and predict judicial decisions) also believes that these studies have failed to produce successful predictions because they do not take into account the "personality of the judge". With this syntagm, Leiter seems to refer to facts that in order to be identified require a psychoanalytic process, see Leiter, *Naturalizing*, pp. 56 et seq., 93.

[46] Leiter, *Naturalizing*, p. 43: "If these considerations are correct, then any explanation of the decision solely in terms of reasons, legal or non-legal, will necessarily be incomplete. The Realist goal is to locate and articulate the real cause of the decision, which requires going beyond the domain of reasons."

[47] Leiter, *Naturalizing*, p. 10.

[48] Leiter, *Naturalizing*, p. 10.

[49] I take into account the sophisticated theoretical and philosophical reconstruction of American Legal Realism offered by Leiter, *Naturalizing*.

[50] Davidson, 'Actions, Reasons, Causes', pp. 3–21.

By legal reasons it is understood, using Brian Leiter's definition, the ones a judge can legitimately use to justify his or her decision: "(1) the legitimate sources of law (e.g., statutes, court decisions, morality, a constitution, etc.); (2) the legitimate methods of interpreting sources of law (e.g., intentionalism, originalism, purposive interpretation, structural interpretation, "strict" and "loose" readings of precedent); (3) the legitimate ways of characterizing the facts of a case in terms of their legal significance; and (4) the legitimate ways of reasoning with legal rules and legally described facts (e.g., deductive reasoning, reasoning by analogy)".[51] By extra-legal reasons it is understood all that reasons that are not elements of the components of the class of legal reasons, but despite this they are included between the factors of the judicial decision-making.[52] The two types of rationalization are useful to explain the actions of the agents (judges): pointing to the "actual" reasons that explain – i.e. the reasons that serve as a sufficient cause of the action – the judicial decision-making.[53] That is, these are reasons that are relevant to explaining why the judge made a certain decision D1 and no other alternative judicial decision D2, D3 or D4, etc.

2. **Ontological and Epistemological Beliefs**. If legal reasons are not determinants of judicial decisions and, therefore, are not sufficient to explain them,[54] it is necessary to take into account other factors (i.e. [extra]legal reasons and facts) and other explanatory strategies of judicial decision-making: on the one hand, the sort of *teleological explanation* connected to the economic and psychological (normative or descriptive) rationalization, and on the other, naturalistic or mechanical explanation.

The three approaches share the following beliefs:

Ontological belief: it is believed (or assumed) that law is rationally indeterminate (i.e. the reasons – e.g. legal rules – are insufficient to determine a single judicial decision, and therefore do not serve to explain it).[55]

[51] Leiter, *Naturalizing*, p. 9.

[52] It can be said that extralegal reasons are not based on "legal language": the set of norms (or meanings ascribed to "legal sources" through interpretation); the methodologies of interpretation and argumentation suggested by both "legal scholarship" (i.e. "usual academic investigation into the law, especially into those normative texts which are regarded as the official sources of law", see Guastini, 'Juristenrecht. Inventing Rights, Obligations, and Powers') and "past judicial decisions".

[53] Davidson, 'Actions, Reasons, Causes', pp. 3: "by giving the agent's reason for doing what he did."

[54] Brian Leiter, 'Naturalism in Legal Philosophy'; id., *Naturalizing*, pp. 9–10.

[55] Therefore, these three views consider inadequate the ontological belief according to which legal reasons – that is, the ones a judge can legitimately use to justify his or her decision – determine, or are sufficient cause of, a single judicial decision. Leiter, *Naturalizing*, pp. 9 et seqq.

To this belief about what the law is like there corresponds an epistemological belief about how we can (or must) know it (e.g. how to explain and predict judicial decisions):

Epistemological belief: it is believed that the fruitful way to explain and predict judicial decisions is through factors that are determinants (i.e. causes) of such decisions (i.e. effects), that is, factors that are sufficient to explain them[56]; or (i) through (extra)legal reasons (specially, reasons different from legal rules), i.e. *teleological explanation* or (ii) through facts (which are different from the fact of acceptance of reasons or social values by the judge, e.g. legal certainty, the maximization of wealth, redistributive justice, etc.), i.e. *mechanical explanation*.

3. **Predictive-Theoretical Objectives and Products**. The three views share the theoretical objective of explaining and predicting judicial decisions.[57]

The evidence obtained by the psycho-cognitive theory seems to provide an incentive for the (Neoclassical) economic theory to, on the one hand, improve the way it approaches judicial decision-making[58] and, on the other, provide opportunities for the economic theory to relax its restrictions (e.g. only the marginal costs and benefits alter the decision; sunk costs are not relevant in the current decision of an agent; choosing one alternative among others, that is the decision, is the only measure of utility,[59] etc.) and thus improve its descriptive validity.[60] Therefore, today, the economic analysis seems to accept assumptions that are psychologically more plausible.[61]

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[56]Leiter, *Naturalizing*, p. 40: "Why not replace, then, the 'sterile' foundational program of justifying some one legal outcome on the basis of the applicable legal reasons, with a descriptive/explanatory account of what input (that is, what combination of facts and reasons) produces what output (i.e. what judicial decision)?".

[57]Holmes, p. 457: "For surely one of the most familiar themes in the writings of the Realists is their interest in predicting judicial decisions (or prophesying them, as some Realists put it)"; according to Leiter, this theoretical activity (prediction) is necessary to meet the theoretical and pragmatic interest of American Legal Realism: "to produce a pragmatically valuable theory for lawyers, i.e. one that will enable them to predict what courts will do"; Leiter, *Naturalizing*, p. 25. See also Llewellyn, *Bramble Bush*, p. 4; Moore, pp. 609–617; Frank, p. 46; Felix Cohen, pp. 828 et seq., 839.

[58]Posner, 'Rational Choice', pp. 1559 et seq., 1567.

[59]Kahneman, p. 165.

[60]Thaler, 'Psychology and Economics', pp. S282 et seq.; since the emergence of the cognitive psychological paradigm 30 years ago, the gap between economic and psychological approaches to decision-making seems to have decreased. Such an approach has been stimulated by economists and by psychologists alike: cf. Simon, 'Behavioral Model', pp. 99–118; Simon, 'Alternative Visions', pp. 189–204. See also Rabin and Thaler, pp. 219–232. See also Sen, pp. 317–344; Kahneman, Knetsch and Thaler, 'Fairness', pp. 728–741; Kahneman, Knetsch and Thaler, 'Endowment Effect', pp. 1325–1348; Kahneman and Snell, pp. 187–200; Kahenam, Wakker and Sarin, pp. 375–405; Kahneman and Tversky, 'Prospect Theory', pp. 263–292.

[61]Posner, 'Rational Choice', p. 1567; see also Daniel Kahneman, 'A Psychological Perspective on Economics'.

Moreover, if, as I mentioned earlier, the naturalistic approach wants a mechanical explanatory strategy that explains judicial decision-making "beyond reasons", then its products seems to complement the ones (that may be) obtained with the economic and psychological teleological explanatory strategies, i.e. normative and descriptive rationalization, respectively.

4. **Determinant of the Judicial Decision: The Personality of the Judge**. The three approaches consider the personality of the judge as a main determinant of the decision.[62]

It is obvious that the psychological strategy seeks to account for the personality of the (judge) agent since it describes his or her psychological profile. The appropriateness of this strategy – i.e. descriptive explanatory-rationalization – to achieving this theoretical end seems to be out of discussion.

On the other hand, it seems that there is not agreement, at this point, about the compatibility of the economic approach with the other two approaches: the economic strategy, being based on the RDT and, therefore, on normative rationalization (or normative teleological explanation), is inadequate to account for the actual personality of the judge.[63] It simply does not care a penny about the actual personality of judges; it dwells on a totally different plane. It deals with a specific and "virtual" aspect of human beings[64]: i.e. they are self-regarding; they want to obtain the best with their decisions (i.e. to maximize their expected utility).

However, it seems to me, the theory of judicial decision offered by, for example, Posner – who is a model of the thinkers that believe that RDT and, therefore, teleological explanation are useful for explaining and predicting judicial decisions – acknowledges the judge's personality as a determinant of judicial decision-making. Even if it is difficult to say that this is a traditional object of EAL. Posner considers (federal) judges as ordinary people, ordinary human beings that (virtually)[65] have the goal of maximize their expected utility and that are provided with instrumental reasoning (that is, with a means or tool) for reaching it. They are, therefore, susceptible to economic analysis.[66] Thus, Posner takes into account incentives, other than explicit market prices – obviously, if judges are presumed to be honest – that influence the judge's decision-making and are understood by what he called the

[62] Some exponents of American legal realism insist on the same; cf. Frank, p. 111. See also Llewellyn, 'Realism', pp. 1242 et seq.

[63] Leiter, 'Holmes', p. 312.

[64] Pettit, 'The Virtual Reality of "Homo Economicus"'.

[65] Pettit, 'The Virtual Reality of "Homo Economicus"'.

[66] Posner, 'Judges Maximize?', p. 110. See also Posner, *Economic Analysis*, pp. 572 et seqq.: "Similarly, the fact that judicial decisions are sometimes influenced by the race, religion, gender, or other personal characteristics of the judge need not be an effect of agency costs. It may merely reflect the fact that people from different backgrounds are likely to bring different priorities to their resolution of factual issues and to have different policy preferences because of differences in life experiences." See also Drobak and North, pp. 147–152. See also Miles and Sunstein, p. 843.

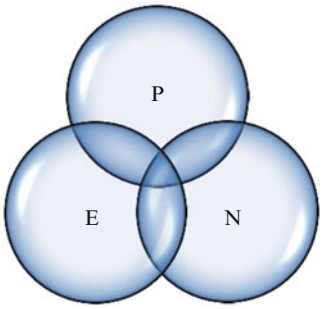

Fig. 5.1 Synoptic graphic S

"judicial utility function".[67] Among the preferences that maximize the utility of the judges are: leisure and less work, looking for prestige or popularity among trial lawyers, other judges and the general public; prevent the rejection of its own decisions by higher authorities or by legislative intervention, and so on. This is, in my opinion, one serviceable way – unique and different from the one to be preferred by the naturalistic approach – to consider the personality of the judge as a factor of the judicial decision.

In brief, let us see the differences (or specificities) and compatibilities exposed above in the following graphic of sets **S** (Fig. 5.1). Where **S** is for **[P** ∪ **E** ∪ **N]**, that is, the not exhaustive set of sub-sets of features of different strategies (**P**sycho-cognitive, **E**conomic and **N**aturalistic). The symbol ∪ expresses the union between sub-sets; the symbol ∩ expresses the intersection (or features that are compatibles) between sub-sets; and the symbol / expresses the differences between, or specificities of, sub-sets (e.g. X/Y means, all that is X but it is not Y).

1. ***Specificities***:

   (i) E/(P ∪ N) = [E/N] ∪ [E/P] = {normative rationalization; description is not a prior-step of explanation and prediction: unrealistic assumptions, *homo economicus*, e.g. agent is endowed with a stable set of preferences; RDT, EUT; direction of fit (↑) world to word . . . }
   (ii) P/(N ∪ E) = [P/N] ∪ [P/E]= {descriptive rationalization; PT; emotions . . . }
   (iii) N/(P ∪ E) = [N/P] ∪ [N/E]= {mechanical explanation; explanation does not refer to agent's intentions for acting (i.e. for decision-making), but to factors that are beyond reasons (i.e. facts) . . . }

2. ***Compatibilities***:

   (i) [**N** ∩ **E**] = [**P** ∩ **N** ∩ **E**] = common compatibilities {causal explanation; ontological and epistemological beliefs; predictive products; judge's personality . . . }; [E ∩ N]/P = empty= {∅}

[67] Posner, 'Judges Maximize?', pp. 117 et seqq.

(ii) [**E** ∩ **P**]/N = {teleological explanation; are based on instrumental rationality; this explanation of action refers to agent's purpose or goal that informs the intention for acting . . . }

(iii) [**N** ∩ **P**]/E= {description is a prior-step of explanation and prediction; direction of fit (↓) word to world; realistic assumptions *homo psychologicus*, e.g. is endowed with an adjustable and dynamic level of aspirations; *homo naturalis*, e.g. "is gullible, naïve and easily fooled, and susceptible to being controlled, used and manipulated [. . .]"....}

5.3 About a Pragmatic Epistemological Option

For Leiter, as I will discuss later, instrumental rationality – on which the RDT is based – is not adequate to describe, explain and predict judicial decisions.[68] However, instrumental rationality is adequate, from an anti-foundational epistemological point of view,[69] to choosing one theory (and its corresponding strategy) over another.

For Leiter, "pragmatism" means that some epistemic norms and beliefs must be accepted, based on a "posteriori utility criteria", simply "because they 'work' relative to human various ends".[70] This suggests that a pragmatic epistemological decision consists in choosing a theory of judicial decision that is the "best", the most "useful" in comparative terms, for explaining and predicting judicial decisions.

Leiter considers that *we must choose the psychological and/or naturalistic strategies and reject the economic one*.[71] This decision presupposes two sub-decisions: preferring psychological strategy to the economic one (Sect. 5.3.1); preferring naturalistic strategy to the economic one (Sect. 5.3.2).

Hereinafter, taking into account the aspects that are different and compatible across the three strategies (see *supra* Fig. 5.1), I will argue that Leiter's epistemological decision is unfounded from a pragmatic point of view (which is the one that Leiter presumes to accept).

On the one hand, respect to sub-decision (Sect. 5.3.1), the epistemological decision is unfounded, because economic and psychological strategies are different in nature and provide different products, so are not interchangeable with one another. Then, for choosing one strategy over the other one, the only possible utility criterion is the predictive successfulness of each one of these strategies. On the other hand, respect to sub-decision (Sect. 5.3.2), the epistemological decision is unfounded for the same reasons outlined regarding the first sub-decision (that is, because economic and naturalistic strategies are different in nature and provide different products, and because it is not based on utility criteria of predictive successfulness). Finally

[68] Leiter, 'Holmes', pp. 306, 312.

[69] Point of view that is based on Quine's philosophical works, see Leiter, *Naturalizing*, pp. 3, 30–34, especially 36 et seqq.

[70] Leiter, *Naturalizing*, p. 49.

[71] Leiter,'Holmes', pp. 301, 309, 311.

(Sect. 5.3.3), I am going to explain how economics, which is based on a normative theory, could be considered like an adequate strategy for explaining and predicting judicial decisions, at least in commercial disputes, based on a pragmatic utility criterion of availability.

5.3.1 Psychological Strategy Versus Economic Strategy

Economics is the most formalized of the human sciences. Nonetheless, Leiter says, it "[. . .] has none of the successes of, say, empirical cognitive psychology over the past quarter century".[72]

Despite this, after three decades, the current status of the dispute between the economic and psychological approaches does not allow one to point to a defeated and a winning strategy, as Leiter seems to suggest.

Leiter's preference is not aware of the epistemological agreement between the economic and psychological views about the falsity of the following two statements: (i) the RDT is a descriptive theory of decision-making; (ii) economic analysis is useless to explain and predict decisions.[73]

Leiter seems to agree with the falsehood of the first of these statements, but not with the falsehood of the second.

Regarding the first statement, no one seems to accept that the homo economicus is a realistic psychological portrait of people when making decisions. There seems to be, rather, an agreement according to which the economic agent is an approximation[74] (or fiction), or in other words, a peripheral and non-focal aspect of individuals making everyday decisions.[75]

From the falsehood of statements (i) and (ii), it follows that, contrary to what Leiter seems to suggest, the descriptive fault of the RDT does not necessarily imply that it is an inadequate theory to predict judicial decisions. Perhaps the empirical evidence has shown that the EUT is a false descriptive theory, but there is still not enough evidence (and generalizations that are applicable to the real world, not to designed decision-making scenarios) to show that the psychological-cognitive theory is better in explaining and predicting judicial decision-making.[76]

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[72]Leiter, 'Holmes', p. 309.

[73]Thaler, 'Psychology and Economics', p. S283: "the following two false statements. 1. Rational models are useless. 2. All behavior is rational: [. . .] If everyone would agree that these statements are false, then no one would have to waste any time repudiating them."

[74]Daniel Kahneman, 'A Psychological Perspective on Economics'.

[75]Cf. Pettit, pp. 308–329, especially pp. 317 et seqq.

[76]Cf. Drobak and North, pp. 147, 151: "Although behavioral psychologists and cognitive scientists have studied decision-making for centuries, our knowledge of the brain's processes is still very primitive [. . .] With brain scanning, chemical testing, and other new techniques, researchers are pushing the frontiers of medical knowledge of the brain's processes. But there is still a great amount of research to be done. It is important for scholars – from medicine, psychology, cognition,

Moreover, Leiter's disagreement about the falsity of statement (ii) seems unaware of what economists and psychologists have accepted: the peculiar nature of each of the economic and psychological strategies and the products thereof. If these strategies provide products of a different nature, they cannot be considered substitutes of each other. One could say, rather, that both views, economic and psychological, propose different theories of rationality and their explanations are also of different kind.

Economic theory is normative: the criterion (or axiom) of rationality of this theory is the maximization of expected utility. This theory is based on means-to-an-end instrumental rationality to explain and predict decision-making.

The psychological theory is cognitive: it describes the decision-making process; it describes the means-to-an-end instrumental rationality of people, and based on this description it explains and predicts decisions.

Moreover, the theoretical and explanatory teleological statements produced by the psychological strategy view lack the deliberative aspect (axiomatic or normative) of the technical-explanatory teleological means-to-an-end statements produced by the economic view. In other words, such theoretical-explanatory statements do not offer a practical response to the question raised by judges about which decision to take. Obviously, according to Humean law, norms cannot be derived from a descriptive theory such as this one.[77] Then, "unlike the paradoxes of expected-utility theory, violations of the invariance cannot be defended as normative".[78]

It is also true that the technical-explanatory means-to-an-end, statements of the economic strategy, lack the theoretical and descriptive aspects of the psychological strategy. Put another way, such technical-explanatory statements do not serve to account (perhaps only contingently)[79] for how judges actually make decisions.

Moreover, as Kahneman noted, despite the approximation between economic analysis and psycho-cognitive analysis, the first is based on the assumptions of the RDT: economic analysis still seems stable and it continues to restrict the approximation between economics and psychology.[80] Kahneman also notes that even though the psychological approach finds the base-assumption of the economic strategy strange and simplistic, it is still used in economic theory for an important reason: "[it] allow[s] for tractable analysis. The constraint of tractability can be satisfied with somewhat more complex models [i.e. the psychological model], but

economics, and law – to continue to probe the human decision-making processes. However, until we truly understand much more about how people make decisions, we cannot replace the rationality-based models."

[77] Thaler, 'Psychology and Economics', p. S281; Kahneman, p. 163.

[78] Kahneman, p. 163.

[79] The economic strategy could be considered descriptive of behaviour of (judges) agents only if they meet the axioms of TDR in judicial decision-making -that is, when technical and normative statements of economic strategy are effective in judicial practice. And this is a contingent matter, i.e. something that is not necessary, but only possible (See *infra* Sect. 5.3.3).

[80] Kahneman, pp. 165 et seq.

the number of parameters can be added is small".[81] In this sense, Kahneman suggests that RDT continues to provide the basic framework of economic analysis: "even for these models, in which the agents are 'fully rational except for . . . ' some particular deviation that explains a family of anomalies".[82]

Kahneman, in addition, seems to suggest that the cognitive theory is not an alternative to economic theory, given that

> [. . .] models of behavioral economics cannot stray too far from the original set of assumptions [. . .] theoretical innovations in behavioral economics may be destined to be noncumulative: when a new model is developed to account for an anomaly of the basic theory [RDT], the parameters that were modified in earlier models will often be restored to their original settings. Thus, it now appears likely that the gap between the views in the two disciplines has been permanently narrowed, but there are no immediate prospects of economics and psychology sharing a common theory of human behavior.[83]

This suggests that the psychological strategy is not considered a theory that can replace economic theory. As I said before, each theory makes use of explanatory strategies with different products. The cognitive theory is descriptive, while the economic theory is normative (and also believes it can ignore the descriptive products of the PT). In this sense, Kahneman and Tversky note that normative and descriptive analyses are very different: "Consequently, the dream of constructing a theory that is acceptable both descriptively and normatively appears unrealizable [. . .] the normative and the descriptive analyses should be viewed as separate enterprises."[84]

Since there are two theories that make use of strategies with varying products, the only possible argument to justify (from a pragmatic epistemological view) the preference and rejection of one or another strategy is an open empirical question:

> A good aspiration for both conventional [RDT] and behavioral approaches is careful empirical work that provides reasonably definitive conclusions about predictive failures and successes.[85]

So choosing the psychological strategy over the economic strategy can only be based on the utility criterion of predictive successfulness of each strategy, that is, on the empirical testing of the predictions made by both strategies in the real world

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[81] Kahneman, p. 166.

[82] Kahneman, p. 163.

[83] Kahneman, p. 166. See also Posner, 'Rational Choice', pp. 1558–1560: "[. . .] behavioral economics is the negative of rational-choice economics – the residuum of social phenomena unexplained by it [. . .] they do not have a economic theory to set against rational-choice theory [. . .] If there is any theory in their approach, it is not an economic theory. They take a psychological approach to phenomena that are sociological and psychological as much as they are economic, yet call their approach economic. It is as if they thought economics the only social science, which if true would mean that any social scientific critique of economics must itself be a part of economics."

[84] Kahneman and Tversky, 'Framing Decisions', pp. S251–S278, especially S252, S272, S275.

[85] Jolls, Sunstein and Thaler, pp. 1500 et seq.; see also Sunstein, p. 9.

(not in hypothetical scenarios of decision-making) in which (judicial) decisions take place. Hence Leiter's epistemological option cannot be justified on pragmatic terms: indeed, he does not offer evidence (i.e. empirical data) to justify his epistemic preference for the psychological strategy over the economic one for explaining and predicting judicial decisions.

Leiter's preference for the psychological strategy is understandable from another (non-pragmatic) point of view. Both the naturalistic and psychological strategies give greater importance to the psychological description of the decision maker (i.e. the judge) as a *necessary* step for the prediction of the (judicial) decision. However, the explanatory style of the second strategy, unlike the first, is descriptive *rationalization*. So the psychological (descriptive-teleological explanation) strategy is incompatible with the strategy (mechanical explanation or natural causation) desired by NJ. The psychological theory explains decisions without restricting the explanations to facts, contrary to how it is wanted by the naturalistic approach.

5.3.2 Economic Strategy Versus Naturalistic Strategy

Despite the significant similarities (which have been recognized)[86] between the normative theory of EAL and American Legal Realism, Leiter claims that, the economic (technical-teleological-means-to-an-end explanatory) strategy is not adequate to explain and predict judicial decisions. (This seems to be valid to him even in commercial disputes).

The naturalistic theory calls for a strategy that must be useful for (i) describing how judges make decisions; (ii) explaining and predicting beyond reasons; (iii) making quantitative or qualitative better, and successful, predictions.

It is true, as Leiter argues, that EAL does not work to describe how judges make decisions[87]; is inadequate to identify patterns of regular behaviour beyond the instrumental rationality (and the RDT) that is at the basis of its explanatory strategy[88]; has a very poor empirical record, because its generalizations do not have the form of (quantitative) laws on which to make accurate, reliable and successful predictions.[89]

Then, EAL does not meet the requirements of the explanatory strategy that is aimed by the naturalistic approach. But this is not a sound reason for rejecting

[86]See, Chiassoni, pp. 271–327. See also, Brian Leiter, 'In Praise of Realism (And Against "Nonsense" Jurisprudence)'. See also id., *Naturalizing*, p. 95: "Economic analysis, like Realism, seems predicated on a thoroughgoing skepticism about the adequacy of existing legal categories, and the need for an alternative explanation of the actual course of decisions."

[87]Leiter, 'Holmes', p. 310.

[88]Leiter, 'Holmes', p. 311.

[89]Leiter, 'Holmes', pp. 307 et seq., 310: "All I have shown is that economic 'science' is a failed empirical program."

economic strategy, which is very different from naturalistic strategy (like we have seen before, Fig. 5.1): each one of these two strategies offers different products.[90] In addition, it is true that:

(i) For the EAL the description of the decision-making process is not a necessary step, at best contingent, to make predictions. Assumptions about the agent do not need to be psychologically real for predicting judicial decision-making. This view sees judges as if they were rational agents aiming to maximize utility (e.g. social wealth or a personal utility) through their decisions. This psychologically unrealistic (but virtual) assumption is part of its teleological-explanatory and predictive strategy of judicial decisions.[91]

(ii) The explanatory strategy of EAL has a different scope of application in comparison to the one of the explanatory strategy of the naturalistic approach. Based on the RDT, the EAL does not intend to identify patterns of behaviour beyond what can be identified through legal and extra-legal reasons. The nature of its explanatory strategy (i.e. teleological explanation: normative rationalization of judicial decisions through instrumental rationality) does not allow for it. In other words, the explanatory strategy of the economic approach does not even intend (as it is desired by the NJ) to explain judicial decisions through psychosocial facts (not reasons) about the judge (i.e. through mechanical explanation).

(iii) Generalizations that can be made from the RDT are not the kind of laws – as Leiter recognizes[92] – upon which it is possible to make accurate and reliable quantitative predictions, as is required by the naturalistic approach. Based on Donald Davidson arguments, the causal relationships that serve to connect reasons and actions – e.g. (extra) legal reasons and judicial decisions – cannot take the form of laws (in the scientific sense) on which to base accurate and reliable predictions of the explained actions.[93] In this sense, Davidson adds, "[. . .] Laws [in the scientific sense, not legal] are involved essentially

[90]The EAL teleological-explanatory statements are technical means-to-an-end (with direction of fit of the decision-making process ↑): how to acquire a particular purpose (i.e. the maximization of wealth). In contrast, the mechanical-explanatory statements of the naturalistic view are theoretical (with direction of fit ↓): how judges make decisions (i.e. descriptive statements of judicial decision-making).

[91]Kraus, p. 330: "The assumption of rational profit maximization, for example, has a significant power in explaining and predicting the outcome in corporate and commercial law cases."

[92]Leiter, 'Holmes', pp. 308, 310: "Scientific laws, to repeat, need not be 'strict' in the Davidsonian sense of specifying with precision all of the parameters of the boundary conditions that fall under *ceteris paribus* clauses. But over the time, genuine scientific research programs are distinguished by their ability to at least approximate or approach strictness, even if they never realize it [. . .] After all, a quantitatively precise science of human affairs does not seem to be on the horizon from any source." Notwithstanding, Leiter's recognize that: "[. . .] a quantitatively precise science of human affairs does not seem to be on the horizon from any source."

[93]Davidson, 'Actions, Reasons, Causes', pp. 15 et seq.

> in ordinary causal explanations, but not in rationalizations".[94] The kinds of generalizations that can be made by means of rationalization are not predictive type-laws in the strict sense.[95]

On the other hand, the most powerful argument provided by Leiter against economic strategy is that it "is a failed empirical research", because it has a poor empirical record of successful predictions.[96] However, we still cannot say, based on the utility criteria of predictive successfulness, that one theory is better than the other for predicting judicial decisions: which of the two strategies is better for such goal is an open empirical question.

Then Leiter's arguments do not justify, from a pragmatic epistemological point of view, why a naturalistic strategy should be preferred to the economic one.[97] In other words, Leiter offers no argument to show the futility of RDT in the explanation and prediction of judicial decisions, nor the greater usefulness of the naturalistic strategy in explaining and predicting such decisions. The absence of arguments weighs more if we think in commercial disputes, in which intuitively it can be said that EAL seems to be an adequate method.[98]

5.3.3 A Normative Theory for Explaining and Predicting

Between the strategies that have been analysed here, the economic one is the only strategy that is based on a normative theory (RDT). This is a feature that characterizes the peculiarity of economics approaching judicial decision-making (see *supra* Fig. 5.1). Hereinafter, I will deal with an unavoidable problem: in what

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[94]Davidson, 'Actions, Reasons, Causes', p. 15.

[95]Davidson, 'Hempel on Explaining Action', p. 213: "I have argued that a causal relation implies the existence of strict laws belonging to a closed system of laws and ways of describing events, and that there are no such laws governing the occurrence of events described in psychological terms; we seldom if ever know how to describe actions or their psychological causes in such a way as to allow them to fall under strict laws. It would follow that we can explain actions by reference to reasons without knowing laws that link them." See also id., 'Actions, Reasons, Causes', p. 17.

[96]Leiter, 'Holmes', p. 310.

[97]Leiter, 'Holmes', p. 312: "It does remain, then, an open question whether naturalized jurisprudence, in my sense, should supplant the economic theory of judicial decision-making favoured by Posner." But even if Leiter recognizes that it is an open question, it is also true that he bets on the necessity of replace the former strategy with the latter one: "What is clearer is that the poor empirical record of economics demands that we seek alternatives to the dismal science."

[98]EAL seems to do a good job in predicting, with a useful qualitative level, judicial decisions in commercial disputes: See, Kraus, pp. 329–331: "The predictive failures of economics do not, by themselves, justify the wholesale rejection of economics by anyone [...]. Economics lacks the kind of predictive precision that hard science requires because of the complexity of the phenomena it seeks to describe, explain and predict [...]. The problem is not the integrity of the kind of accounts it seeks to provide, but the complexity of the real-world macro-phenomena it seeks to explain."

sense can it be said that EAL is an explanatory and predictive strategy, despite being based on a normative theory of rational choice? How a normative theory can help to explain and predict judicial decisions? Is instrumental rationality (and teleological explanation) useless for explaining and predicting judicial decisions?

Just as Leiter said, based on sound intuitive grounds, that psychoanalytic method would be adequate for explaining judicial decisions in constitutional law matters,[99] it could be said that economic method seems to be adequate for explaining and predicting judicial decisions in commercial disputes (e.g. antitrust cases).

There is a virtual aspect of people's personality, i.e. people are "implicitly self-regarding".[100] This is an aspect that in certain contexts (especially in commercial disputes) emerges to pose and solve a decision problem. Decision problems in which the assumption of the businessman, postulated by Friedman, is not at all useless.[101] Using Simon terms, the "level of aspiration" of people in the market and in commercial disputes is very high (they are satisfied with the best!). Corporations calculate the expected value of their long-term decisions (according to EUT). That people fail most of the time to make rational decisions (from the point of view of RDT), does not mean that people, for example, the businessmen, do not actually want to (or that they cannot effectively) learn how to maximize their own profit; or that they do not seek an expert advice before making a decision when what is in dispute is a large stake. The businessmen (like all human beings) regret their wrong decisions, and they have the ability to learn from their mistakes through counterfactual inductive inference.

Then, it could be said that instrumental rationality is useful to deal with the "self-regarding" aspect of agent's personality. It is useful in the situation where a judge ought to decide a dispute between businessmen, and when he or she wants to make decisions prudently, that is, decisions economically justified from the commercialized point of view of a capitalist society. In situations where the judge must deal with businessmen that *expect* that "efficiency" informs judicial decisions

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[99]Leiter, *Naturalizing*, p. 93: "[. . .] psychoanalytic explanations are, importantly, on a continuum with ordinary folk psychological explanations, and as with folk explanations [. . .] in areas like constitutional law – where the issues engage the personality of the judge in special ways – we need to reconsider the merits of Frank's approach to psychoanalytic method."

[100]Pettit, p. 320.

[101]Friedman, pp. 13 et seq.: "Confidence in the maximization-of-returns hypothesis is justified by evidence of a very different character [. . .] unless the behavior of businessmen in some way or other approximated behavior consistent with the maximization of returns, it seems unlikely that they would remain in business for long. Let the apparent immediate determinant of business behavior be anything at all – habitual reaction, random chance, or whatnot. Whenever this determinant happens to lead to behavior consistent with rational and informed maximization of returns, the business will prosper and acquire resources with which to expand; whenever it does not, the business will tend to lose resources and can be kept in existence only by the addition of resources from outside. The process of 'natural selection' thus helps to validate the hypothesis – or, rather, given natural selection, acceptance of the hypothesis can be based largely on the judgment that it summarizes appropriately the conditions for survival."

in commercial disputes in the same way in which "efficiency" informs deliberations and decisions in their own commercial affairs.

It is true that the homo economicus assumption conflicts with people's everyday deliberations and decisions. People most of the time are not self-regarding, but this does not mean that such an assumption does not have any presence: "it may be virtually if not actually there [. . .] there are certain alarm bells that make them take thought to their own interest [. . .] the alarm bells ring and prompt them to consider personal advantage; and heeding considerations of personal advantage leads people, generally if not invariable, to act so as to secure that advantage: they are disposed to do the relatively more self-regarding thing". So, homo economicus is "virtually present in deliberation, for there are alarms which are ready to ring at any point where the agent's interest get to be possibly compromised and those alarms will call up self-regard and give it more or less controlling deliberative presence". The alarm bells ring when people are "in a terrain too dangerous from a self-interest point of view". In such decisions problems, "they will quickly begin to count the more personal losses and benefits that are at stake in the decision at hand".[102]

Economic strategy uses instrumental reasoning in its teleological explanations, and also in its normative statements (both of them informed by the RDT). These two uses of such type of reasoning, and then of the RDT by economics can be explained with Elster's words: the RDT "is first of all normative, and only secondarily explanatory. It begins by stating how agents should act in order to realize their goals, and then proposes to explain their actions on the hypothesis that they actually behave in that manner."[103]

It is possible to identify two kinds of EAL (both based on RDT), one that it is directed to the set of rules that is the law, another one that it is directed to the self-interested personality of the judge who applies the law: (i) a traditional EAL assumes that the result, which the judge wants to achieve with her decision, is that of, for instance, maximizing the social wealth; (ii) an alternative EAL (the strategic one) assumes that the result that is desired by the judge is that of maximizing her personal utility, e.g. to increase her reputation between the other judges, lawyers and general community.[104]

(i) The psychological fact of acceptance of a norm, or external reason, (e.g. maximization of social wealth) by the judge is necessary for explaining and predicting a judicial decision informed by such a norm. Then the fact that economics works for explaining and predicting judicial decisions depends on a contingent matter.

[102] Pettit, pp. 317–320: "Let the considerations push the agent below the relevant self-regarding level of aspiration and the alarm bells will ring, causing the agent to rethink and probably reshape the project at hand."

[103] Elster, p. 14.

[104] Miceli and Cosgel, pp. 31–51; see Posner, 'Judges Maximize?', pp. 117 et seqq.

Through sociological cognition the social values and ideologies that are accepted by judges and that (normatively) inform judicial decision-making can be identified. Among the values that can be identified there is, *for instance*, the "maximization of wealth" (i.e. the meter that serves to compare, in cost-benefit terms, alternative courses of action or decisions). If hypothetically this is the value which informs judicial decision-making by a judge or a court in a specific kind of cases (e.g. in commercial disputes), and in a concrete time and place, then it is not unreasonable to believe that future decisions made by such judge or court will also be informed by such value. Thus, we can say that EAL can be considered an explanatory-predictive strategy if and only if it is the truth that the judge accepts (for whatever reason) the value, and therefore the goal, of maximizing social wealth with his or her decision. He or she can do that, independently of the reasons of the judge for looking for that goal, e.g. by commitment or self-interest. In the former case, for example, because he or she has a very good knowledge and academic background in EAL; in the latter, because he or she would like to prevent the criticism of a capitalist society which considers that wealth maximization is the social value that must inform judicial decisions[105] in commercial disputes. In this sense, Leiter recognizes that Posner is "the more effective moral entrepreneur, one who exploits the antecedent intuitions of jurist in a thoroughly capitalist and commercialized society; for whom "efficiency" and welfare-maximization require no argument"[106]; and for whom, it could be added, the ideology of "law as a giant price machine" has a lot of believers (both judges and censors of judicial decisions).

The norm of judicial decision-making that requires the maximization of social wealth and the cost-benefit analysis to be taken into account could turn out to be effective, because it asks the judge to make a decision which can be made within her abilities – or the judge has the capacity as well of acquiring the ability needed for doing this thing,[107] e.g. making a decision that is the most efficient in Kaldor and Hicks terms.[108]

The means-to-an-end-cost-benefit analysis is a useful tool in one of two senses.

Normative cost-benefit analysis: the application of normative cost-benefit analysis serves to answer the practical question posted by the judge about which judicial decision to make and states how to act rationally in situations that fit on a predetermined shape. EAL, for example, recommends that judicial decision-making

[105] As Chiassoni, pp. 294, 299 et seq., recognizes, according to EAL, the reasoning of lawyers and judges ought to be means-to-an-end, such that its legal reasoning remain "exposed to the control of public opinion legally and economically warned, both concerning its value premises [i.e. socially relevant purposes that are intended to promote] and its factual or theoretical assumptions".

[106] Brian Leiter, 'In Praise of Realism (And Against "Nonsense" Jurisprudence)'.

[107] von Wright, p. 50.

[108] Based on the criterion of Kaldor-Hicks efficiency, EAL deems that the best means are those that consent to reach the end with the lowest possible cost. For Posner, the conditions of applicability of Kaldor and Hicks criteria (or also known as Potential Pareto Superiority) unlike the conditions of applicability of the Pareto efficiency criterion, do occur in real life, see Posner, *Economic Analysis*, p. 12.

should to be guided by the social wealth maximization value. For EAL, judicial reasoning can only consist of the cost-benefit analysis of the consequences of each alternative decision that could be made. In other words, the EAL recommends taking into account the costs and benefits of different decision's outcomes (outputs) that are exclusive and jointly exhaustive. The judicial decision will be efficient, based on the criterion of wealth maximization if and only if the resource (in dispute) is assigned to the person with the greatest willingness and ability to pay for it, if it would be possible, in the market.[109]

Explanatory-predictive cost-benefit analysis: the cost-benefit analysis serves to explain decision-making: the application of explanatory-predictive cost-benefit analysis, serves to explain the decisions made by agents who are assumed to have the ability of instrumental reasoning: "Desires and beliefs are reasons for action. A rational actor chooses the action that will realize his desire as well as possible given his beliefs and the totality of his other desires."[110] If it is accepted the common sense assumption according to which judges, as human beings, are capable of acting with a purpose[111] (e.g. maximization of social wealth, W), then it could be expected that "[i]f the judge J has the purpose of W, probably or certainly, J will follow the course of action A". Then, if it is justified to believe (based on empirical and sociological data) that a specific judge or tribunal accepts this social value in this kind of disputes, we could predict which will be, probably, the unique judicial decision, i.e. the correct decision from RDT and EAL points of view.[112]

In short, according to the assumption of the rational agent and the application of cost-benefit analysis, it can be explained why the judge acts in the way he or she does under certain circumstances and also predictions can be made about the judicial decision in future decision problems that are similar to the problem or case at hand. To be sure, the psychological fact of acceptance is a contingent matter. But it is a necessary one when considering that an economic tool could work to explain and predict judicial decisions. Economic strategy works (contingently) for explaining and predicting judicial decisions: it works where people and judges effectively accept that, for example, the social value of wealth-maximization must inform judicial decision-making in commercial disputes. And where it is accepted that judges "[. . .] have to back up their value assertions with money, or some equivalent sacrifice of alternative opportunities".[113]

Money plays a very important role in human commercial affairs, because of the status function that is attributed to it collectively.[114] Money, to quote Ronald Coase, allows calculations performed by economic strategy to be more precise

[109]Coleman, Chap. 3, 4; see also Chiassoni, p. 272.

[110]Elster, p. 16.

[111]Michael E. Bratman, *Intention, Plans, and Practical Reason*.

[112]On the explanatory-predictive aspect of RDT see Bermudez, p. 7.

[113]Richard Posner, *Economic Analysis of Law*.

[114]Searle, p. 17.

about human behavior. Economics is the most advanced of the social sciences, not for it theoretical sophistication, but due to "the happenstance that the economist has a convenient measuring rod – money – which enables his observations to be more precise than would be possible otherwise".[115] The status function of money is an important reason by which the assumptions and implications of economics hypotheses are, at least contingently, plausible and functional. The assumption of an agent who wants to maximize his or her expected utility (measured by the willingness to pay) could be used. If these assumptions and implications are plausible, "willingness to pay imparts credibility to a claim of superior value than forensic energy does".[116]

So, EAL is a normative theory of judicial decision that also has explicative and predictive powers. RDT and EAL provide norms (i.e. maximization of expected utility, for example, maximization of wealth) that seem to be effective means to an end, and that also seem to be consistent with the nature and limitations of judges. So, EAL seems to make a difference in the practice of judicial decision-making, because it is possible that there are judges with the ability of following such norms in decision-making. Then it could also be said that normative considerations of EAL are reasons for the action of the judge. For instance, the social wealth maximization norm seems (sometimes) to engage the desires of judges and "to make vivid to the [judge] agent what he or she is already disposed to care about"[117] in commercial disputes.

The virtual effectiveness of normative cost-benefit analysis seems to be out of discussion. Leiter affirms that the normative weight of the advice that Oliver Wendell Holmes directs to judges, to calculate the social advantage to be gained against the social advantage to be lost (i.e. cost-benefit analysis[118]) with its *nomopoietic*

[115]Posner, 'Coase', pp. 207 et seq.

[116]Richard Posner, *Economic Analysis of Law*.

[117]It could be said that EAL, as the realist, in commercial disputes (Brian Leiter, 'In Praise of Realism (And Against "Nonsense" Jurisprudence)'; see also id., *Naturalizing*, p. 30): "advocated using general norms, reflecting the norms that judges actually employ anyway [. . .]. Typically, the Realists argue that what judges decide on the facts in such cases [i.e. commercial disputes] falls into one of two patterns; either (1) judges enforce the norms of the prevailing commercial culture; or (2) they try to reach the decision that is socio-economically best under the circumstances." See also Leiter, 'Holmes', p. 298: "Although he speaks of the judge's 'duty of weighing considerations of social advantage', he quickly makes clear that as normative advice it does not amount to much, for this is what courts do anyway! 'The duty is inevitable' says Holmes, so telling judges that they 'ought' to weigh social advantage only amounts to the modest suggestion that they do openly what they do anyway, albeit 'inarticulate[ly], and often unconscious[ly].'"

[118]For example, think about the Hand Rule or Learned Hand formula (i.e. what counts as negligent conduct depends on a cost-benefit analysis: there is liability for negligence where the expected value of damages exceeds the cost of its avoidance) which is used by judges in liability law cases: see Posner, 'Negligence', pp. 29–96. See also Mathis, pp. 20 et seqq. Think about "Coase's theorem" that has a good (even if not infallible) explanatory-predictive power. It is possible to think also on antitrust cases, where efficiency is an effective directive in judicial decision-making.

decisions, is futile: it is what judges do effectively in the practice of judicial decisions in commercial disputes, in which most realists were so interested.[119]

(ii) For the alternative EAL, it is possible to assume that the judge is a self-interested human being and that she aims to maximize her personal utility (e.g. to increase her reputation). If this is true, then RDT can be applied to judicial decision-making; it is necessary to assume which personal end or result the judge wants to attain with her decision – e.g. to attain coordination between her expectations and the expectations of the others judges about her decision – and which possible decision would be the best for achieving it.[120]

In closing, in the meanwhile, until we have evidence (about predictive successfulness) in favour of one of the three strategies, it seems to be reasonable to opt for a different epistemic (pragmatic) decision based on the utility criteria of availability, i.e. we must use the available strategies for explaining and predicting judicial decisions. It is true that strategies with successful, or at least more accurate and reliable, predictions than those provided by the economic strategy, are always desirable. But economics seems to be nowadays a useful and available tool for predicting (with some empirical record in commercial disputes) such kind of decisions.[121] Further, it could be said that "judicial utility function"[122] seems to be very useful (as an alternative to the traditional EAL) for explaining and predicting judicial decisions, based on the virtual self-interested and strategic *personality* of the judge.

In brief, the rejection of (traditional or alternative) EAL as an explanatory-predictive strategy is unfounded. The EAL strategy is different from both the naturalistic and psychological strategies; one that seems to be (or is potentially)

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[119] Leiter, *Naturalizing*, p. 30; see also Brian Leiter, 'In Praise of Realism (And Against "Nonsense" Jurisprudence)'; see also id., 'Holmes', p. 298.

[120] It is possible to suppose that judge expects that she maximize her "social reputation utility" by conforming her decision to, for example, the maximization of social wealth. In this case, traditional EAL seems to fit in explaining and predicting the judicial decision at hand. But also it is possible to suppose that judge expects that she maximizes her social reputation by conforming her decision, not to the maximization of the wealth but, for example, to the expectations of a social minority. In this case, traditional EAL has not much to say; but maybe the alternative EAL (the one that looks for the personal preferences of the judge) has something useful to say.

[121] See Kraus, pp. 330 et seq.: "[. . .] the challenge from law-and-economics is to find a theory that accounts for the vast majority of the outcomes in corporate and commercial law cases with the same consistency that this theory does. In my judgment, there are no close contenders. Economics provides an invaluable tool for organizing statutory and case law materials in commercial law and for predicting the likely outcome of cases in this area [. . .] As long as people are capable of acting rationally, even if not consistently, a normative theory that requires or presupposes that individuals act rationally is not futile and thus pointless. If we look again to corporate and commercial law, where the rationality and profit-maximizing assumptions of economics are most at home, the normative force of economics analysis is considerable. Nothing, therefore, would prevent Holmes, the classical realist about law, from embracing economic analysis as a normative theory."

[122] Posner, 'Judges Maximize?', pp. 117 et seqq.

useful in explaining and predicting judicial decision-making. It is therefore a strategy that can be used by a realist interested in the teleological explanation and (with a potentially progressive-qualitative level of) prediction of such decisions.

5.4 Concluding Remarks

Two possible pragmatic-epistemological justifications (based on two different utility criteria) for choosing and rejecting strategies have been outlined here: (1) the first one is based on an open empirical epistemic-decision-problem: which of the three strategies (psychological, economic and naturalistic) is (most) useful to explain and predict judicial decisions? (2) The second one, rather, justifies the usefulness of the three strategies simply because they are available and also they seems to work for explaining and predicting judicial-decisions.

Leiter does not offer a pragmatic epistemological justification. His arguments are based neither on the two utilities criteria outlined above ("predictive successfulness" and "availability") nor on another types of utility criteria.

Moreover, it has been suggested here, contrary Leiter's option, to accept the economic strategy for explaining and predicting judicial decisions, at least in commercial disputes (e.g. antitrust cases): economic strategy is, (un)fortunately, an available tool with some (and not irrelevant) empirical records of successful predictions in such kind of decisions. It has been said too that RDT (or strategic or alternative EAL) is useful for explaining judicial decisions based on the virtual self-interest personality of the judge.

In brief, an epistemological pragmatic decision (i.e. rejection and preference of strategies) must be based, first, on evidence about the predictive failures and successes of each of the three strategies exposed above. Secondly, if this evidence is not offered, it is possible to accept, also from a pragmatic point of view, that there are three *realistic*, *different*, *complementary*, *available*, and *useful* strategies in explaining and predicting judicial decision-making; three approaches which focus on *different* aspects of the personality of the judge, and hence irreplaceable with one another. To argue this has been the main aim of this essay.

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Chapter 6
Some Thoughts on Economic Reasoning in Appellate Courts and Legal Scholarship

With Norwegian Illustrations in Three Legal Dimensions

Endre Stavang

Abstract Economists find it worthwhile to study the effects of law, and to offer explanations or recommendations in light of such studies. Lawyers also contribute to this same enterprise, i.e., using the intellectual tools typically developed and used by economists. A lawyer may do this because it has intrinsic (intellectual) value or because it is relevant, by which I mean that it is proper from the perspective of legal methodology (and, if applicable, his or her's own preferences). In this chapter, examples from Norway of such relevance are offered based on personal experienced as a judge and as a legal scholar. First, the intrinsic ingredient of economics in law is suggested using three appellate court cases that I co-decided for illustrative purposes. Secondly, three Norwegian contributions to legal scholarship are discussed to shed light on a demarcation problem that may arise more often in Europe than many other places and also to suggest more could and should be done to fuse economic analysis of law and doctrinalism. Thirdly, and relatedly, three principles for bridging economic reason and legal argument are highlighted. Although the main goal is to reflect normatively and exploratory on professional norms from the standpoint of someone who has internalized these norms, the chapter simultaneously reports "field data" contradicting Posner's claim that economic analysis of law is congenial to American judges only (Posner, *Legal Theory*, p. 42) and Eidenmüller's claim that it is a prerogative for the Legislator to take economic analysis of law into account (Eidenmüller, p. 490).

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6.1 Introduction

6.1.1 Economic Reasoning

Economics is sometimes defined with emphasis on subject matter (money, markets and public spending, etc.); at other times it is understood as a way of thinking (aided by concepts like rationality, equilibrium and allocative efficiency). The latter understanding is implied when economists and lawyers develop and apply economic analysis of law. Here, "economic reasoning" refers to both deliberate efforts to apply economic insights as well as legal arguments which are very reasonable rationalized as resulting from the intent to apply economic insights.[1]

6.1.2 Courts and Legal Scholarship

The general theme in this essay is economics *in* law, not economics *of* law. The discussion is however limited to courts, and to legal scholarship focusing on courts. This of course narrows down the scope of the chapter in comparison with the breath of the underlying theme, as it is of course imperative to remember that lawyers also argue and bargain outside the courtroom and outside the scope of legal disputes.[2] The relevance of economics is clear in many such contexts, e.g., when bargaining, drafting and entering into a commercial *contract*. Moreover, when lawyers assist in *legislative* work, they should not only (in my opinion) defer to other social scientists and to lawyers who know social science. They are even under an obligation to analyse the effects of legal change and to assess its costs and benefits. This obligation is not only universal and ethically grounded, but is also a requirement in Norway and many other jurisdictions, like the US and the UK.

The practice of *judging* lies, however, at the core of professional law, at least according to traditional understandings. The reason is – as we all know – that the courts decide the precise content of the law, and that it is a profitable and professionally prestigious craft to argue before the judges and to predict and interpret their rulings. And the core of legal scholarship is closely attached to these activities. Thus, it is reasonable to assume that a discussion of economics in courts and legal scholarship may shed light on the more general theme of economic reasoning in law.

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[1] In presenting my case, which is the case of Norway since 1980, I am assuming a certain minimum knowledge concerning the perspective and methodology of economic analysis of law, see e.g. Erling Eide and Endre Stavang, *Rettsøkonomi*; Richard Posner, *Economic Analysis of Law*; Steven Shavell, *Foundations of Economic Analysis of Law*; Hans-Bernd Schäfer and Claus Ott, *The Economic Analysis of Civil Law*.

[2] See e.g. Robert H. Mnookin, Scott R. Peppet and Andrew S. Tulumello, *Beyond Winning. Negotiating to Create Value in Deals and Disputes*.

6.1.3 Norwegian Illustrations

The illustrations of and references to economic reasoning in Norwegian law are in this chapter organized along three legal dimensions: the practice of judging, the practice of courts-centered legal scholarship and the mainstream jurisprudential model of decision-making in courts ("interpretation").

The main argument for discussing the legal relevance of economics in Norway only, is that such relevance ultimately has to be judged within a given jurisdiction, and that Norway is an interesting case because Scandinavia is considered to be different from both the German-speaking as well as the English-speaking jurisdictions.[3]

Although Norway may not represent Scandinavia perfectly, it may be argued that it is the one Scandinavian jurisdiction where the discussion has been going on for the longest time and with the greatest intensity. Since 1840 Norwegian lawyers have been taught economics as part of their program of studies leading to a law degree. From 1996, the curriculum was changed from a general, broad introduction to economics to an introductory course in economic analysis of law. To pre-empt any impression of chauvinism, I hasten to add that the most prominent individuals in the relevant debates during the twentieth century – Henry Ussing, Vilhelm Lundstedt, Alf Ross and Jan Hellner – were not Norwegians, but rather Danes (Ussing and Ross) and Swedes (Lundstedt and Hellner). I maintain however, that since 1980, the leadership in the debate has gradually gravitated towards the law school at the University of Oslo. Erling Eide – the first Norwegian professional economist to take economic analysis of law seriously – was appointed Professor of Economics at this law school in that year.[4]

Although the relevance of economics is contingent on professional and political culture, as well as on social and moral norms, I would be surprised if the illustrations, examples and generalisation in this chapter were to be of no interest to those who want to explore the foundations and applications of "law and economics" in Europe, and even elsewhere.

6.1.4 Outline

Following a bottom-up sequence, three cases in torts, contracts and intellectual property that I co-decided as an appellate court judge are discussed first (Sect. 6.2). Then, three important contributions from three of my colleagues in Oslo are considered in light of my own understanding of economic analysis of law and its status and standing as a form of legal scholarship (Sect. 6.3). On the basis of this

[3] See Grechenig and Gelter, p. 297.

[4] Røsæg, Schäfer and Stavang, p. 18.

experience, I offer some thoughts on a somewhat more theorized methodological level on how to go from economic reason to legal argument (Sect. 6.4). In closing, I remark on the potentially counter-intuitive character of the claims made herein and draw some conclusions (Sect. 6.5).

6.2 Illustrating How Economics is Intrinsic in Law

6.2.1 Introduction

This section is based on my own (admittedly very limited) experience as an appellate court judge, in the Borgarting court of Norway. During the winter of 2003–2004, I co-authored over a dozen opinions, and I have selected three of them as vehicles for illustrating the relevance of economics in the Norwegian legal system.

An Apartment Sale

The first case is *a contracts case* concerning a possible price reduction for the buyer of an apartment due to the fact that the seller *ex ante* did not in fact legally control an 8 m^2 hall outside the apartment for sale, despite the fact that the hall during the contract negotiations was represented as being part of what was sold.[5]

When approaching such a case, it might be helpful to consider that a legal burden which has not been allocated by the parties should during trial, if possible, be put on the party best placed to carry it, in the sense that this party most cheaply can prevent such problems from arising, or that he has a superior capacity to carry the ex-ante risk that the costs related to such problems may entail.

In fact, the court found that this lack of legal control, which both parties failed to realize, was a risk that was to be allocated to the seller. Thus, a price reduction was rewarded. The court's main stated reason for this allocation was that to apply the opposite rule in such a case would risk sending a signal to buyers that they should use legal representation when buying an apartment. At the same time the court said that it found more appropriate that the broker (who in the Norwegian legal system is an agent for the seller but still under an obligation to take both parties' interests duly into account) possesses and uses a reasonable knowledge of real property law. Moreover, the court found that the seller in this case had failed to do so.

This analysis may not impress an economist, but the idea here is clearly to save on transaction costs (the cost of hiring a lawyer) and to allocate risk with an eye to the incentive effects of such risk allocation. Thus, economic reasoning was clearly part of the *ratio decidendi.* Such elements in the decisions of the court may

[5]LB-2003-997.

enhance future predictability to the benefit of both contracting and litigating parties. Moreover, it moves us in the direction of basing court decisions on broader notions of collective rationality – even (in) civil law cases. Such a move is reasonable given that the courts are subsidized by the public purse. Even if the economic reasoning was not necessary to reach the result (i.e. during "the process of discovery") in this case, I would claim that it was a desirable element to justify the decision at the appellate level.

In sum, this case gives some hints and indications as to how and why economics is relevant in contracts cases.

A Loss of Income After a Road Accident

The second case is *a tort case*, involving economic loss arising out of a car accident resulting in personal injury.[6] The victim owned all the shares in a small manufacturing and installation company which made its profits mainly by the extraordinary talent and efforts of the victim. The court awarded damage compensation for all lost salary. In dispute was only whether non-salary income was a protected interest in tort, either through a claim from the victim as a physical person for lost dividends, or through a claim from his company (which he fully owned) for lost profits. Both claims had been filed, but the court did not discuss the last claim, as it unanimously found in favour of the victim for his personal claim of dividends (the first claim).

Economics is a rather apparent factor in the court's reasoning, in two ways. On the one hand, there is a human capital and production theory flavour in the finding by the court that the dividends loss in reality was a loss of personal income. The court noted that the business had very low fixed costs. And even if there were a handful of other employees, the victims' working hours, creativity and personal engagement in the business was so significant that there was a negligible distinction in this case between the salary and the dividends to the victim. On the other hand, the following reasons dictated that lost salaries and lost dividends were *both* compensable. First, there was no risk of compensation for loss twice, given that the second claim was dropped given that the first claim was honoured. Second, car accident insurance would be cheaper than socially desirable if the random gain (to the injurer) of not being liable for the full harm were chosen as the solution. Third, administrative costs and related technical problems did not constitute powerful counterarguments to awarding damages for the full harm.

This is not the full story, however. The Borgarting ruling was appealed, and the Supreme Court subsequently – with three votes against two – limited the injurer's liability to the victim's salary loss.[7] The majority said it would be "unfamiliar/foreign to our legal system" if personal damage compensation of dividends to the victim was awarded, that it also would run counter to "basic company law principles" and

[6] LB-2003-14218.

[7] Rt. 2004, p. 1816.

that it would complicate computation of damages and taxes. The immediate victim was the company, and due to all the three stated counterarguments, only the latter's loss of profits was compensable – given that the company itself had sued for such damages, which it had. However, the company's loss of profits was, to the majority, so unrelated with the personal injury that it constituted a pure economic loss not worthy of compensation under current doctrine. The fact that part of the harm was thus not compensated, and that the injurer and its insurer thus benefited arbitrarily from this configuration of facts and doctrine were not deemed sufficient arguments to allow either of the two claims to be honoured. – The minority voted in favour of upholding the ruling of Borgarting appeal court, and explicitly stated that it found that the majority's position unreasonable.

For the lower court and for the Supreme Court minority, there is no doubt that economic reasoning permeated the premises of the decision. For the Supreme Court majority, it is not easy to assess the role of economics, because who can divine what is hidden in the phrases "unfamiliar/foreign to our legal system" and "basic company law principles"? It may just be that these judges held the view that what has crystallized itself as familiar and basic is precisely what is economically desirable. Moreover, administrative costs clearly entered into the majority's reasoning as a relevant component. That the majority did not tackle the economic issues head on and explicitly, however, makes its premises more muddy than necessary. The majority would have been on firmer ground had they said something like this: The loss is a pure economic loss to the company and the non-compensation of pure economic losses can in this case be defended on the grounds that if companies can seek damages for loss of income due to the personal injury of employees, this would lead to too many (difficult) cases and many uncertain measurements. Similarly, if shareholders can sue for losses suffered by companies, when losses are pure economic losses to the company, there will be many more cases that in general would have to be dealt with through class action suits. Moreover, the deterrence effect is probably small in this instance. And finally, this is the kind of loss that the owner might insure against himself through personal injury insurance.[8]

As a matter of fact, *none* of the judges in this case considered whether the dividends were components of the loss which shared its characteristics with other so-called pure economic loss. If this were the case, compensating for such loss could lead to overcompensation and to overdeterrence. In my opinion, the quality of the opinions on this issue would have benefited from better wording – for the same basic reasons as stated with regard to the contracts case above.

In sum, this case illustrates that a torts case can be decided and its justifications improved by highlighting its economic dimensions. And in contrast to the apartment case discussed above, a stronger knowledge of and commitment to economic reason might have prevented what I think in the end was the wrong result in this case.

[8]I thank Henrik Lando for this input.

A Copyright Infringement

The third case is *a widely discussed intellectual property case involving the use of a criminal sanction*.[9] It is sometimes called the DeCSS-case, also referred to as the DVD-Jon case. Jon Lech Johansen, then 15 years old, circumvented in 1999 the Content Scrambling System for DVDs, and posted this on the Internet, making the program available to persons without any special knowledge of information technology. In the appellate court, we found that the development of the program was not illegal, and that access to the films could not be qualified as unauthorized. Thus, there was no basis in Norwegian criminal law for punishing Johansen, and he was thus acquitted.

The economic reasoning of the court is sparse, and, if it exists at all, it is buried in the following paragraph of the ruling:

> It is the opinion of the appellate court that there is a qualified difference between copying a feature movie and reproducing a whole issue of a journal or a whole book. The feature movie is stored on a medium prone to be harmed like scratches, nicks and cracks, while a book or a journal may be read over and over again without reducing the quality. The appellate court bases its opinion on a DVD being vulnerable to injuries to such an extent that the purchaser must be permitted to make a copy, for instance of a movie in which he takes a special interest in preserving. One cannot see that the use of DeCSS represents any great danger for illegal reproduction of DVDs in competition with the movie producers. The legal history and the Berne Convention art 9 stipulates a weighing of interests, but in this case it is the interpretation of the copyright act sect 12 as part of an assessment of criminal law which is the issue, and in such a legal context the unconditional form of the wording of the provisions must, according to the view of the appellate court, be given considerable weight.

It is evident from this paragraph that the court may have catered to a kind of cost benefit analysis, but that it deviated from performing one because of the wording of the Norwegian copyright act.

Despite this, I would argue that this case is still a good example of the relevance of economic analysis of law. Why? First, in the proceedings of the case, significant attention was given to an expert testimony on whether or not an acquittal of Johansen in effect would transform existing DVD movies on market from a private good into a public good and thus dilutes the incentives to produce new films. In retrospect, I think that the prosecutor and her witness should have made more of this argument, not less. The witness based his statement on textbook theory without support of sufficient data, and the prosecutor did not integrate the expert testimony into her legal reasoning to a sufficient extent. If this had been done, it is not possible to rule out the possibility of a different outcome of the case, or at least a dissent, giving a reason for further appeal to the Supreme Court. And given such an appeal, which I actually think would have been appropriate in any case; an expanded version of the expert testimony could and should have been presented before the Supreme Court.

[9] 03–00731 M/02 Oslo Lagsogn.

Given a slightly different legal take on the problem, this economic analysis of law then could and should have figured prominently in the final ruling.

In sum, this illustrates that economics may well be part of the basis for deciding copyright cases.[10] In fact it was not, however. Thus, of the three case discussed, the one where the parties themselves explicitly ventured into economic reasoning, the court was more reluctant to take economic reason into account, relative to the two cases where the parties themselves did not mention such arguments explicitly.

6.2.2 General Remark in Closing

It is somewhat ironic that, of the three case discussed, the one where the parties themselves explicitly ventured into economic reasoning (Sect. "A Copyright Infringement"), the court was more reluctant to take economic reason into account, relative to the two cases where the parties themselves did not mention such arguments explicitly (Sects. "An Apartment Sale" and "A Loss of Income After a Road Accident"). Nevertheless, based on my – admittedly short – experience, I suspect that it is not rare to find cases in Norway that are fruitfully subject to economic reasoning, and laboured through the use of tools of economic analysis of law. I close this section by noting that such labouring would not be in breach of the theory of adjudication which is propagated at the University of Oslo. According to this theory, which is supported by empirical observation, policy arguments are a valid and indeed desirable part of ascertaining and deciding the law, and of justifying the particular outcome of a case.[11] And if we ask ourselves specifically how economic analysis of law fits into this theory, the answer is: not bad at all, see Sect. 6.4 below.

6.3 Fusing Economic Analysis of Law and Doctrinalism?

6.3.1 Examples

In this section, illustrations are given and discussed concerning how economic analysis of law is conducted and used among today's legal academics in Norway. I will discuss three main examples and mention several others.

The first scholarly work is Trine-Lise Wilhelmsen's monograph on unconscionability and other grounds for reasonableness-based invalidation and revision of contract terms; see the Norwegian Contract Formation Act, section 36, versions

[10] Stephen Breyer, 'Economic Reasoning and Judicial Review' (discussing, i.a., a US copyright case).

[11] The canonical exposition is Torstein Eckhoff, *Rettskildelære*.

of which appear in all the Nordic jurisdictions.[12] The *theme* of the monograph is to what extent this law contributes to economic efficiency.

To understand the *method* of the monograph, it may be useful to compare it with the much earlier study by Posner and Rosenfield on impossibility.[13] There, the issue for decision is considered in respect of the party who should bear the loss in the typical case in which an unforeseen event makes the cost of performance exceed the benefits, such as war (events with general effects) and death (events with individual effects). Thus, the object of study is the legal solution to the discharge problem, which is dealt with by the doctrines of impossibility, frustration, and impracticability. If any of these doctrines apply, the promisor is excused for non-performance, and the promisee is only entitled to the restitution of value of actual benefits to the promisor. According to Posner and Rosenfield, the efficiency-based prediction is based on two analytical elements. The first element is to establish proper incentives for care and insurance, that is, that discharge should be allowed where the promisee is the superior risk bearer. The second element which underlies the prediction is the economics of rules versus standards, that is, an analysis which takes into account the costs and benefits of deciding case by case. The analysis leads Posner and Rosenfield to conclude "that the doctrine exemplifies the implicit economic logic of the common law".[14]

Wilhelmsen's monograph is structurally similar to Posner and Rosenfield's study, but there are some differences. Her main basis for deriving efficiency implications is Cooter and Ulens framework for the economic analysis of contract law as set out in their textbook.[15] This gives a more general approach based on the notion of perfect markets and contracts. The various parts of article § 36 and the underlying case law is then thoroughly analysed and compared with what would be efficient given assumed relevant market and contract imperfections. Like Posner and Rosenfield, Wilhemsen thus identify the economic decision problem regardless of doctrinal distinctions, and specify an efficient solution to the legal problem. Unlike them however, Wilhelmsen does not discuss whether the solution should be implemented as a rule or at the level of individual cases. On the contrary, she compares the actual outcome of each case with the "efficient" outcome of the same case. Wilhelmsen's result is that the correspondence is 80 %, but she avoids the claim that she "explains" the law by exposing this "empirical" correspondence. She does, however, interpret the result as having legal significance.

The second scholarly work is Hans Christian Bugge's monograph on environmental civil liability (and the PPP, i.e. "polluter pays principle").[16] The book is

[12] Trine-Lise Wilhelmsen, 'Avtaleloven § 36 og økonomisk effektivitet'.

[13] Richard A. Posner and Andrew M. Rosenfield, 'Impossibility and Related Doctrines in Contract Law: An Economic Analysis'.

[14] Posner and Rosenfield, p. 84.

[15] Cooter and Ulen, chapters 6 and 7.

[16] Hans Christian Bugge, *Forurensningsansvaret. Det økonomiske ansvar for å forebygge, reparere og erstatte skade ved forurensning.*

mainly a detailed exposition and analysis along doctrinal lines, but the law is in addition commented upon in light of three normative criteria: the ecological goal to keep the environment clean, the economic goal to minimize social costs, and the legal goal to pursue justice. The criteria themselves are thoroughly described in separate parts and are then used at various stages throughout the book as a basis for remarks on the law. An overall message of the book is that the polluter-pays principle (PPP) is more ambiguous than what was thought at the time. The principle originates in environmental economics and the idea that all resources – including natural resources and other environmental qualities – will be efficiently managed if all costs – environmental costs included – are internalized in the operating decision system of the polluting firms. When the positive effect of the environment for the welfare of all individuals thus are duly taken into account, then the firm will count environmental harm caused by the firm as a cost. But despite this clear PPP concept, the PPP notion is in practice used in several ways, and Bugge discusses the various legal implications of different interpretations of the PPP.

The third scholarly work is Gunnar Nordén's article on the legal regulation and position of the Norwegian Central Bank.[17] The article concerns the legal autonomy of the Bank and analyses whether the central government is legally competent to give instructions to the Bank, and whether the Bank is under some kind of duty to adhere to "political signals" (in the form of budget documents, etc.) from Parliament. Nordén asks specifically how statutory language on the Bank's legal position is to be interpreted in the light of this overall theme. His analysis contains an ambitious combination of formal norm-analytical discussions in the Scandinavian legal realist tradition and game-theoretical discussions of the dynamic consistency issues that can be raised within the institutional arrangements in question. Nordén's result is that the Norwegian central bank has – de lege lata – more autonomy than what conventional legal wisdom postulates, and that, on the level of the theory for legal interpretation ("rechtsquellen-lehre"), we must reject in statutory interpretation the use of budgetary documents and similar sources produced by the political system after the promulgation of the statute.

I will now discuss some differences between these three contributions and also try to assess their qualities with regard to their use of economics and to their representativeness in this respect.

The three contributions are different in that Wilhelmsen's studies of whether judges are in fact reasoning in line with economics when they decide on unconscionability, Bugge discusses the role (partly economic) of a legal principle, and Nordén uses economics to interpret the law – three very different uses of economics in law indeed. The main parameter, however, that I will use to *distinguish* the works are the sophistication and internalization by the author in question of the economic analysis that is used to produce the text, and the relative attention that is paid to this aspect of the overall problem. Here, it is Nordén and Wilhelmsen who pay most

[17]Gunnar Nordén, 'Norges Banks rettslige stilling: En systemorientert analyse med implikasjoner på nivået for juridisk metode'.

attention to economics and of these, Nordén is clearly the one that has internalized economics the most. The internalization by Bugge is comparable to Wilhelmsen's, but in contrast to her (and to Nordén), he "puts economics in its place" by giving it the role as the second of three analytical pillars/values and thus limits the attention to it accordingly.

All three works have been received as contributions to Norwegian legal scholarship at the highest level. I do not seek to second-guess these assessments of quality. Rather, I will try to assess whether they are good models for others that want to do legal scholarship at PhD-level or beyond.

Nordén's sophistication is outside the reach of almost all legal scholars. Moreover, I admit to a certain scepticism regarding his use of symbolic notation and a very developed level of formal reasoning. The basis of my scepticism is that he postulates that his work has a legal-practical purpose, and to me, that clearly constrains the appropriateness of formal analysis, at least when it is not translated and transparently integrated into the (other) legal reasoning.

Bugge's work seems to me the better model for most legal scholars aspiring to incorporate economic analysis of law. The economics is clearly set out, and the relevance is made apparent in a commonsensical, although not trivial, way. I do think, however, that he discusses so many topics that his normative analysis is more superficial than necessary. And to me, this actually results in a rather fundamental crack in the foundations of his monograph. In the midst of his discussion, he pauses to note that he cannot take his "three-goal-analysis" further, but that "the law as it is", that is, the law which is valid (the Scandinavian term is "*gjeldende rett*") – which he describes elsewhere in his monograph – in any case shows how his three goals are relevant, and the extent to which legal significance ("weight") is attached to each goal. To me, this is not a satisfactory solution, and I think Bugge could and should have allowed himself to integrated legal description and goal analysis more by narrowing the range of topics discussed in the monograph. In fact, one could go so far as to argue that Bugge does not sufficiently appreciate that economics does not represent one of several goals but is rather a goal-instrument analysis that can incorporate many kinds of goals, including fairness, legal security, etc.[18]

I would place *Wilhelmsen's* work in an intermediary position between Bugge's and Nordén's. The reason I think that Bugge's work is a better model for more legal scholars open to economics than Wilhelmsen's, is that he pays more attention to other relevant perspectives than economics. But for the minority of legal scholars that aspire to *specialize* in (the application of) economic analysis of law, Wilhelmsen's work is clearly the better model. Arguably, however, her monograph suffers from a somewhat mechanical use of the perfect competition model; the perfect competition model might not be all that reliable for analysing contract law. Instead, one might, at least today, think that contract theory with the assumption of incomplete contracting should be used more directly to throw light on the legal issues. In other words, the perfect competition model may simply not be the most

[18] I thank Henrik Lando for emphasizing this point in our communication.

fruitful benchmark; presumably one should try to find a theoretical framework as close as possible to the real issues that are involved in cases of unconscionability.[19]

Turning to the representativeness of the three texts, Nordén's article may be categorized as part of "*market law*", broadly conceived. During the last 15 years, at least four "market law PhDs" have been produced which pay significant attention to economic analysis (of law).[20] Thus, even if Nordén's work is somewhat idiosyncratic (and original), his work is in line with a trend in Norwegian market law scholarship at PhD level. Bugge's work falls within *environmental law.* In Norway, it is atypical to do environmental law and economics. This may be surprising, because social concerns and the need for balancing of interests are so obviously important in this field. But Bugge's is not the only exception.[21] Wilhelmsen's monograph contributes to *contract law.* It may come as a surprise that there are only three other contributions in this field which utilize an economic approach.[22]

Finally, it should be emphasized that these and other contributions show that the level of ambition with respect to the sophistication, internalization and use of economics can vary along a wide spectrum. At one end, lawyers are open-minded towards economics and to what economists have to say.[23] Moving from there, we come to studies where lawyers acquire, self-consciously or not, a taste for economic reasoning.[24] Further along the spectrum, we find explicit applications of economic reasoning and results.[25] If the economics is sufficiently internalized, we reach a point where the application itself is also a contribution to economics, but

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[19]I thank Henrik Lando for emphasizing this point in our communication.

[20]Olav Kolstad, *Fra konkurransepolitikk til konkurranserett: samfunnsøkonomisk effektivitet i den konkurranserettsligeanalyse*; Helge Syrstad, *Sentralbankens uavhengighet: en analyse av rettsforholdet mellom sentralbanken og de politiske myndigheter*; Eirik Østerud, *Identifying Exclusionary Abuses by Dominant Undertakings under EU Competition Law: The Spectrum of Tests*; Inger Berg Ørstavik, *Innovasjonsspiralen: patentrettslige, kontraktsrettslige og konkurranserettslige spørsmål ved forbedring av patenterte oppfinnelser*.

[21]Beate Sjåfjell, *Towards a Sustainable European Company Law. A Normative Analysis of the Objectives of EU Law, with the Takeover Directive as a Test Case*; Endre Stavang, *Naborettens forurensningsansvar – prinsipper for tålegrensevurderingen.*

[22]Namely Petri Keskitalo, *From Assumptions to Risk Management: An Analysis of Risk Management for Changing Circumstances in Commercial Contracts, Especially in the Nordic Countries: the Theory of Contractual Risk Management and the Default Norms of Risk Allocation*; Henrik M. Inadomi, *Independent Power Projects in Developing Countries: Legal Investment Protection and Consequences for Development*; Inger Berg Ørstavik, *Innovasjonsspiralen: patentrettslige, kontraktsrettslige og konkurranserettslige spørsmål ved forbedring av patenterte oppfinnelser*.

[23]Helge Syrstad, *Sentralbankens uavhengighet: en analyse av rettsforholdet mellom sentralbanken og de politiske myndigheter.*

[24]Hans Jacob Bull, *Tredjemannsdekninger i forsikringsforhold: en studie av dekningsmodeller, med basis i sjøforsikringsretten og i petroleumskontraktenes ansvars- og forsikringsregulering*.

[25]Olav Kolstad, *Fra konkurransepolitikk til konkurranserett: samfunnsøkonomisk effektivitet i den konkurranserettsligeanalyse*; Olav Kolstad, 'Konkurranseloven som virkemiddel til å fremme "forbrukernes interesser"'; Endre Stavang, 'Tolerance Limits and Temporal Priority in Environmental Civil Liability'; Endre Stavang, *Naborettens forurensningsansvar – prinsipper for tålegrensevurderingen*; Endre Stavang, *Erstatningsrettslig analyse – med særlig vekt på eiendom*

that is beside the point here. More important is the next point as we move along the spectrum, which are the economics-based empirical legal studies.[26] And at the (other) end of the spectrum, we find contributions to the theory building within economic analysis of law.[27]

6.3.2 The Demarcation Problem

Many if not most legal scholars, at least in Europe I think, internalize the core expectations from both the world of professional action and the world of academic analysis and reflection. A certain closing of the legal mind may seem warranted, and a traditional lawyer might respond to all of the above: *should not the legal profession protect its own discipline and method while admitting fruitful contributions from economics – how do we prevent interdisciplinarity from going too far or from turning sour?*

My answer to this is twofold. First, economics is, as indicated in Sect. 6.2, often embedded in legal problems in such a way that it is quite natural for a legal scholar to elaborate also on the economics of his or her subject matter. Thus, it may come as no surprise that the scholarly works mentioned in Sect. 6.3 have all been accepted as legal scholarship. According to formal Norwegian regulations for academic employment and promotion, they are thus counted as "legal science" (rettsvitenskap, Rechtswissenschaft). And second, within the professional world, which Sect. 6.2 draws from, there are very strong forces at work determining what can and what cannot survive. Personally, I doubt that creativity in legal research is currently at a level in Norway where there is a danger that the joint forces of academic research ethics and professional guild-like interests will be too weak to protect the discipline and methods of law. This also goes for the rest of Scandinavia, I should think. And how this problem is to be evaluated in other jurisdictions around the world, I leave to others to ponder.

Thus, my conclusion is that economic analysis of law has, since 1980, established itself as a branch of (interdisciplinary) legal scholarship – just like it has previously in many other jurisdictions. One reason for this positive outcome, I think, is that Norwegian legal culture is pragmatic and open for at least moderate forms of utilitarianism-inspired scholarly work. One might even say that a tradition of doing "law and economics" in Norway existed both inside and outside legal academia

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og miljø; Endre Stavang, *Opphør av servitutter*; Trine-Lise Wilhelmsen, *Årsaksproblemer i erstatningsretten – årsakslærer, formålsbetraktninger og økonomisk effektivitet.*

[26] Erling Eide, *Economics of Crime. Deterrence and the Rational offender*; Anders Christian Stray Ryssdal, *An Economic Analysis of Civil Suits and Appeals*.

[27] There are no Norwegian equivalents to Guido Calabresi, *Costs of Accidents*; Guido Calabresi and Douglas A. Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' and Richard A. Posner, *Economic Analysis of Law.*

during the period of 1814 and up until the Second World War.[28] The discussion in Sect. 6.4 suggests, moreover, that worries are needed on the level of current legal theory about potential problems of transforming economic reason to legal argument.

This conclusion, that one can *safely – at least to a reasonable extent* – do "law and economics" and still be a legal scholar, with the possible effects this may have on academic employment as well as on intangibles, seems correct, based on the observations in this essay. Moreover, I would like to suggest adherence to the following main rule: When a scholar with professional training in law applies economics or does economic analysis of law, the outcome is, if the work satisfies the formal quality criteria, to be deemed a contribution to legal scholarship in the German/Nordic sense of the word (Rechtswissenschaft, rettsvitenskap, "legal science"). I predict that this rule is subject to a very narrow exception, if one exists at all.

Let me end by trying to spell out clearly what I take as the essential inference from all of this. It is not just that economic analysis of issues can be used to throw light on questions relevant to legal scholars and judges, nor is it merely that many issues in legal scholarship that can benefit from an economic perspective. To amplify my conclusion, it is that the concept of "rettsvitenskap" has changed. As a matter of principle, this means that economic analysis of law should now be regarded as commensurable with other forms of legal scholarship. As a practical matter, this implies less discrimination against interdisciplinary legal scholarship and thus more competition for professorships in law previously monopolized in Scandinavia by so-called legal-dogmatic scholars in the narrow sense, that is, "pure" doctrinalists.[29]

6.3.3 The Way Forward

I will close this section by commenting briefly on the three ways Anthony Ogus recently suggested that a legal scholar wanting to "do" economic analysis of law should consider when approaching a field of legal research.[30]

The first approach is to look for problems within the law where an economic understanding has been *underappreciated.* Ogus' point here can be related to my examples in Sect. 6.2 which can be understood as suggesting the need for the study of risk allocation and incentive considerations, in three different areas: IPR rights, the expansion of tort law to cover pure economic loss, and the likewise old issue of the consequence of mutual mistake in contract law. I think it is worth mentioning

[28] Stavang, 'Welfare-Based Torts', pp. 28 et seq.

[29] For sake of good order, I add that I count myself as a legal-dogmatic scholar, although not in the narrowest sense, that is, I do not claim to be "pure".

[30] Ogus, pp. 173–175.

that there is ample room for simple risk/incentive/administrative cost analysis of old legal questions, besides the rather more abstract and/or professionally advanced uses of economics.[31]

The second approach is to venture into the field of *empirical* legal studies, for example by teaming up with other scholars that master statistics and econometrics. As the examples mentioned in Sect. 6.3 indicate, both a lawyer (like Ryssdal) and an economist (like Eide) can perform such studies alone, but I think multiperson projects might more often than not be desirable within this approach to legal scholarship. As my own experience in this field approximates zero, I leave to others to develop this further.

The third approach is to integrate the partial but valuable insights gained by economic analysis of law into the more complicated and multifaceted normative spheres of legal interpretation, construction and critique. As I see it, this is the most useful and promising approach for lawyers to take when taking on economic analysis of law. Moreover, I contend that it follows from my analysis in Sect. 6.4 that, on a methodological level, time has come to acknowledge the *fusion* of economic analysis of law and doctrinalism as *one* way of contributing to legal scholarship. The Norwegian case since 1980 suggests that this is feasible. And to rephrase a line from Steven Shavell, this will be both intellectually satisfying as well as preventive of undesirable decisions made within the legal system.

6.4 Bridging Economic Reason and Legal Argument

6.4.1 Introduction

One might think that the discussion in Sects. 6.2 and 6.3 above, although casuistically, sufficiently (for one short essay) illustrates how economic reasoning can play a role as legal argument in Norwegian law, and that this in itself can be taken as potential lessons for others.

However, some might have unease with such a casuistic approach. A European lawyer might e.g. view the discussion so far as too much "scattered rules" and too little "system and principles (coherence)".[32] Moreover, is might seem to some that the use of economic reasoning in law is inherently political, and that there is a need to make this legitimate on the level of legal theory. In other word, how can economic

[31] Thanks to Henrik Lando for emphasizing this point in our communication.

[32] See Régis Lanneau, 'To What Extent Is the Opposition Between Civil Law and Common Law Relevant for Law and Economics?' and Aurélien Portuese, 'The Case for a Principled Approach to Law and Economics: Efficiency Analysis and General Principles of EU Law'.

arguments be transformed to legal ones? This issue has been discussed in Norway since the early 1990s, and in this section, I will summarize an updated version of my own account.[33]

The point of departure from a jurisprudential point of view, given the Norwegian jurisprudential model of judicial decision-making and welfare economics, is that clear-cut implications of economic reasoning are allowed to enter because "values" or "arguments of substantive goodness" and ideas of substantive justice are seen as intrinsic sources of law. However, these arguments are accepted low weight (according to collision principles) if not backed by more authoritative sources of law. Against this background, I identify and describe three mechanisms through which other sources of law may, when (re)assessed, support the (more) socially desirable solution to the legal problem with additional weight. First, there are substantial areas where private autonomy prevails, e.g. in the law of nuisance and servitudes (Sect. 6.4.2). Secondly, internalization of risk and harmful effects is clearly an operating form of "zweck-rationality" in Norwegian law, e.g. in relation to strict liability in torts (Sect. 6.4.3). Thirdly, direct balancing of interests, which often appears to be consistent with welfare economics, is regarded as important in Norwegian legal reasoning (Sect. 6.4.4).

6.4.2 Private Autonomy

There is a tendency in economic reasoning to prefer outcomes of allocative processes that are set up, when feasible, so that each party is free to say yes or no, and to negotiate, i.e. which are based on markets and on "property rules".[34] The sale of the apartment referred to in Sect. 6.2 is clearly an example. Property rules and private autonomy are interlinked, and Wilhelmsen's study referred to in Sect. 6.3 suggests that this bridge between welfare economics and the law is for real. Thus, private autonomy is a *possible* rhetorical mechanism for transforming an economic reason to legal argument.

Sometimes the legislator explicitly *prescribes* a bias towards private autonomy, as when the Norwegian statutes on co-ownership (joint tenancy), servitudes and nuisance announces that the legal rules, as a starting point, are only default solutions that the parties may opt out of by contract or by legally relevant cooperative behavior.

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[33]Endre Stavang, *Verdiskapingshensyn og juridisk argumentasjon – særlig om lokale miljøskader*; Stavang, *Erstatningsrettslig analyse*, Chapter one. See also Eide and Stavang, esp. Chapter 26. A notable later Norwegian contribution building on this is Olav Kolstad, 'Rettsøkonomi i juridisk argumentasjon'.

[34]The theoretical case for property rules is clearly more attenuated than for markets, see Ayres, p. 200 (no general theory exists).

At other times, it is quite reasonable to *infer* that private autonomy is closely linked to welfare economics, at least within the law of real property. To illustrate, in Norwegian-Danish law of servitudes, the ex-ante controls on creating servitudes are weak and few, whereas the explicit rationale for the existence of servitudes in these jurisdictions, and also elsewhere, is that each servitude produces greater utility than disutility, as seen from the perspective of the typical parties holding the rights to the relevant land.[35]

A special case is the *hypothetical contract*. If a servitude is created by the doctrinal equivalent to adverse possession, it is natural but clearly not decisive that the scope of the created right is connected to the character and extent of prior use. Another important consideration is what scope of the right the parties most likely would have bargained for in a setting of smaller transaction costs.[36] This approach to the delineation of rights is also in use as matter of contract interpretation, and as such it may be seen as means of approximating party autonomy and welfare economics, although not a perfect means in all situations.[37]

Moreover, the Norwegian law of remedies as applied to property in land has, as a way of usefully adding to the basic tort-right to compensation for economic loss, several instances where there are *quasi-contract* delictual liability, i.e. the right to be compensated against the benchmark of what the price would have been had the parties agreed in a negotiation. Such add-on rights to compensation may very well increase deterrence and spur negotiated solutions, although perhaps not as much as punitive damages in some instances. A recent example is the Norwegian Supreme Court case in Rt. 2011 p. 228, where a land developer had knowingly and willingly breached a negative servitude by erecting two rather big buildings rather than one small, as the servitude prescribed. The court awarded – based on quasi-contract – compensation in excess of the economic loss to the servitude holder, but did not order the land developer to disgorge all his profits, nor did it award punitive damages.

As final examples, Norwegian law illustrates that party autonomy considerations and welfare economics might be linked and combined in useful ways in the management of other resources than land, e.g. fish stocks and carbon emissions.[38]

[35] Stavang, *servitutter*, pp. 191 et seq.

[36] Falkanger and Falkanger, p. 315.

[37] Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules'.

[38] Peter Ørebech and Torbjørn Trondsen, *Rettsøkonomi for fornybare ressurser. Teori og empiri – med særlig vekt på forvaltning av fiskeressurser*; Endre Stavang, 'Property in Emissions? Analysis of the Norwegian GHG ETS with references also to the UK and the EU'.

6.4.3 *Internalization ("Pricing") as a Form of Zweck-Rationality*

In contrast to property rules, liability rules works by both allowing and pricing transfers of resources, including harmful behavior, as in the case of the Pigouvian approach to environmental taxation.[39] The income loss/road accident case discussed in Sect. 6.2 may illustrate how such economic reasoning may be used in private law as well. Thus, the proper pricing of resource transfers (including harmful behaviors) is also a possible rhetorical mechanism for transforming an economic argument to a legal argument.

The underlying concept in legal reasoning for pricing is a more general consensus that the law, including private law, should not be an end in itself, but, at least to some extent, a means to increase human welfare. This sentiment can be illustrated by the (older) development of strict liability in torts, as well as by the (newer) legal rhetoric on environmental liability.[40] The definition of compensable value of property in the Norwegian statute on takings, which states that value means an ordinary buyer's willingness to pay for the property, is consistent with this reasoning.[41] Thus, it seems generally important, in fields like torts, takings law and environmental law, to "get the prices right". This is also acknowledged in resource rent taxation, which is an important field in jurisdictions with relative natural resource abundance, and also in ordinary property taxation.

However, it is not always the case that economic reasoning transforms easily and results in improved legal decision-making, as the following example shows.[42]

When the loss of a future stream of income is to be compensated, the yearly sums must be added and "capitalized", i.e. its net present value must be calculated. A crucial component is then the interest rate. If a positive inflation rate is expected, one technique is to inflate each yearly amount accordingly, and then find the net present value using the nominal interest rate in the market. Another technique is to sum up without inflating each yearly amount, but then use the real interest rate in the market for capitalization purposes. The Norwegian Supreme Court consistently mixes these approached by summing up without inflating while still using a nominal market rate to find net present value. This pricing error obviously leads to under compensation and may very well lead to significant social loss in terms of too much taking of property, too many personal injuries, and so on. My view is that this legal anomaly is to be corrected and that it cannot be taken as evidence of the irrelevance of economic reasoning in law.

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[39] For example William Baumol and Wallace Oates, *The theory of Environmental Policy*; Alfred Endres, *Environmental Economics*.

[40] Stavang, 'Welfare Based Torts', pp. 24–29; Endre Stavang, 'Two Challenges for the ECJ when examining the Environmental Liability Directive'.

[41] Statute number 17, 1984, article 5.

[42] Erling Eide, 'Kapitaliseringsrenten og Høyesteretts misforståelse'.

6.4.4 The Weighing of Interests

Sometimes property rules and liability rules are combined, so that behavior with external effects are allowed up to a certain threshold level without any pricing, and then priced by a liability rule or sanctioned by a property rule beyond that level.[43] When insertion of thresholds in the law results in such "hybrid rules", it seems generally socially desirable, from a welfare economic point of view, that the thresholds are set to reflect the relative magnitude of the interest on each side of the relevant equation. The kind of balancing lacking in the DVD-Jon case discussed in Sect. 6.2 (of ex ante disincentives to produce versus ex post increased use) can illustrate this general point. And since balancing or weighing of interests is such a familiar feature of law, this seems like a quite natural rhetorical mechanism for transforming economic reasoning to legal argument.

The so-called "Nordic theory of unlawfulness", developed from 1870, and onwards, emphasized, using contemporary jargon, the centrality of cost-benefit reasoning to determine the abovementioned threshold levels. Although the theory was later criticized and lost hegemony as a general legal theory, its spirit clearly has survived in Norwegian tort law.[44]

Moreover, the Norwegian statute on taking explicitly demands that any taking of property clearly results in greater utility than harm.

This is not to say, however, that a simple requirement of a benefit/cost ratio greater than one is all that can be said about threshold levels in the law. To illustrate, even when put in a welfare-economic nutshell, the principles of Norwegian nuisance law for determining the threshold levels of pollution in the environmental liability context, must include at least the following three elements[45]: First, there are some legal principles that can be taken to describe desirable polluter behavior. Most prominently, under the test of "unnecessary pollution", the polluter may be held to a cost-benefit standard of care. However, since information about ways to abate and how much it costs may be scarce, this basis for liability does not guarantee optimal behavior. Some of this imperfection may be overcome by the factor of "unusual harm" under test of "unreasonable pollution", because what is usual may reflect an efficient community standard. Second, under the general principles of unreasonable pollution, the rule may be characterized as strict polluter liability with the defense of contributory negligence. However, case law concerning the factor of "expectable harm" seems to imply some strict neighbor liability, as well. Whether the factor of expectable harm worries too much about the activity level of neighbors, relative to the activity level of polluters, is hard to say. Third, under the *special rule* that regulates what amounts to unreasonable pollution, characterization is difficult.

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[43] Cooter, p. 1526; Kaplow and Shavell, 'Property Rules', p. 723 (footnote 27), see also pp. 749 et seq. and 753 et seq.

[44] Stavang, 'Welfare-Based Torts', pp. 13–19.

[45] Stavang, 'Tolerance Limits', p. 573.

"Substantial deterioration for a distinguishable group" may be applicable where it is relatively important to regulate the activity level of the polluter, and/or where an insurance rationale for compensation applies.

6.4.5 Closing Remark

It may be that legal realism and pragmatism are stronger traditions in Norway that elsewhere in Europe, so that this "theoretical basis" for bridging economics and law cannot be used elsewhere in Europe. However, whether economic arguments fit the system must in practice, as I see it, be discussed with respect to each "compartment" of the law, e.g. criminal law, procedure, constitutional law, private law and so on. This is a task for a treatise, not a book chapter. In this chapter, however, it has been indicated how economic reasoning relates to those legal metaprinciples that govern legal argumentation de lege lata, as exemplified by the "canonical" model in Norway of legal reasoning, and with examples taken from Norwegian laws of property and obligations. On the level of accepted (in the sense of "herrschende meinung") legal theory in Norway, the starting point is quite simple. Welfare-economic arguments are intrinsically relevant in legal decision-making de lege lata because they belong to a family of arguments that relates to what characterizes a good decision.[46] Without support in formal authority, however, the force of such arguments may be rather small also in Norway, even if it shown in Sect. 6.2 how they are relevant and potentially important also in this setting. But, obviously, the intrinsic argumentative value of welfare-economic arguments can be enhanced by explicit references to such arguments in the legal rules.

It must be admitted that the mechanisms described, which in effect may accord welfare economics considerable weight within the accepted decision-making model, also seem to be operating with regards to other ideas of substantive justice as well. I do not consider, however, whether or not other ideas of justice are at once preferable to and inconsistent with welfare economics. The analysis is still of some value. First, if the purpose of an analysis is explanation, and this ambition is not solely to rely on an internal legal perspective, i.e. how legal actors acting for legal reasons perceive their own activities, there is always a challenge for the analyst to come up with explanatory mechanisms.[47] Let's say for instance that one observes a correlation between the dictates of efficiency (within a given model or set of models) and actual legal rules and reasoning. Then this does obviously is not sufficient as an explanation. What one need is to describe certain social or otherwise meaningful constructs that might mediate and make persuasive the efficiency "explanation". I would suggest that, as one possibility, the rhetorical mechanisms described in

[46] Eckhoff, *Rettskildelære*, Chapter 14; Stavang, *Verdiskapingshensyn*, pp. 8 et seq.

[47] See Diego Moreno-Cruz, 'Three Realistic Strategies for Explaining and Predicting Judicial Decisions'.

this section may come to some use in descriptions with the purpose of explaining observations of efficient legal rules in private law. The explanatory power of the mechanisms is probably low, since the social norms do not seem to eliminate judicial discretion. On the other hand, the efficiency hypothesis of "jurist-made" law cannot be considered improbable by mere reference to the theory (model, doctrine) of legally binding social norms of judicial decision-making. Thus, the analysis makes a (very) minor, but distinct contribution to the positive economic analysis of law.

If, on the other hand, the purpose of the analysis is some kind of legal analysis – *de lege lata or de sententia ferenda*, my claim here is that the discussion in this section suggests that worries are not needed on the level of current legal theory about potential problems of transforming economic reason to legal argument. The discussion in this section suggests three "rhetorical mechanisms" that may help in the transformation of economics to law, or, to rephrase, that creates a kind of overlapping normative territory shared by (top-down) welfare-economic reasoning and (bottom-up) legal intuition and knowledge. The analysis thus contributes to normative legal theory by showing judges how they (at least in some areas of the law) might simultaneously show a concern for welfare economics and still conform to social norms of legal decision-making.

All in all, I have developed my thoughts on the basis of Norwegian law, but I would be surprised if they were to be completely falsified elsewhere in the Nordic countries. And I would hope that the discussion also adds some value to the discussion in the other European jurisdictions, and even elsewhere.

6.5 Conclusion

This essay has illustrated how economics may be inherent in legal problems, and examples have further been given – in three dimensions – as to how this intrinsic legal attribute may be explicated. First, three cases were presented and the actual and/or potential use of economic reasoning in all three of them were highlighted. Second, three works of courts-centered legal scholarship and their use of economics were presented and put into perspective. Third, the canonical model in jurisprudence in Norway was considered, and three rhetorical mechanisms consistent with both theory and practice were identified, resulting in an increased plausibility for a claim that economic reasoning is both legitimate and a fruitful rationalization strategy at the level of legal theory.

It may come as a surprise to the *legal professional* that economics has such (potential) legal significance as propagated in the above. One explanation of a surprising effect may be that economic forces and ideas have influenced law over an extended period of time, and that a certain implicit economic logic or structure of the law has become part of the profession's tacit knowledge. However, it is also possible that the relevance of economics is currently underestimated, and that at least European lawyers need to devote more attention to economic analysis of law. And it is not obvious that this need is greater the more "economic" the legal subject

matter is conceived to be. In legal matters related to money and banking, tax law and competition law, professional economists will often contribute as judges, witnesses or back-office consultants. The practicing lawyers will be more on their own in run-of-the-mill cases like those encountered in Sect. 6.2 above.

All in all, I infer that more emphasis on fusing economic analysis of law and doctrinalism will benefit the profession and society by both helping as well as scrutinizing lawyers and judges, and that this benefit on the margin exceeds the opportunity cost of less purely empirical work and less pure doctrinalism. Such fusion should include theorizing the sources of law and their application to help lawyers and judges stay within the law while making use of economic insights and also to describe mechanisms making the positive economic theory of judge-made and litigation-driven law a more plausible explanatory theory, whatever corroborating evidence may be compiled in favour of such a theory.

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Chapter 7
Cultures of Administrative Law in Europe: From Weberian Bureaucracy to 'Law and Economics'

Klaus Mathis

Is modern government a formal engagement concerned with maintaining order through the establishment of general rules of conduct? Or is it a purposive engagement in which the rules of conduct are interpreted as being incidental to the pursuit of some common good?[1]

Abstract This essay will discuss how economic theories have enriched and influenced administrative jurisprudence and the culture of administrative law in Germany and Switzerland. Starting out from Weber's model of bureaucracy, the essay describes and critically appraises the influences of both the economic theory of bureaucracy and transaction cost theory on new administrative law paradigms such as New Public Management, Steering and Governance. By the same token, it shows an evolution in administrative law culture: whereas Weber presupposed a common rationality that systematic legal systems needed to be based upon, new administrative law is based on value pluralism, governing the different values by formalizing the interactions between players instead of the formalization of values. By doing so, it switches administrative law from top-down regulation based on value monotony to process-oriented networks based on value pluralism.

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[1]Loughlin, p. 27.

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7.1 Introduction

The traditional concept of bureaucracy in administrative law, which goes back to Max Weber, is oriented to principles such as legality and equality of rights, which are aimed at establishing procedural justice and legal certainty. This type of administration is eminently well suited to the liberal constitutional state. In the modern social and service state, by contrast, a tendency towards instrumental programming has been observable for quite some time. Yet an administration orientated to strict rules not only impedes the establishment of distributive justice in the social state, but also hinders efficient service provision, which likewise demands more flexible, instrumental action on the part of state agencies.[2]

In Germany and Switzerland, administrative jurisprudence initially reacted to this need with the concept of "New Public Management". At least in Germany, this was followed by the promotion of a model known as "New Administrative Law scholarship" (*Neue Verwaltungsrechtswissenschaft*) which is based on the impact-oriented paradigm of "steering" (*Steuerung*) in contrast to the traditional juristic administrative-court perspective. The latest tendency is to shift away from the service state towards the "ensuring state", which operates less as a direct service provider and more as a guarantor that tasks will be performed. In many cases, this entails a shift from sovereign to cooperative forms of action on the part of the administration. Subsequently this tendency was absorbed into the governance approach, which now enters into competition with the steering approach.

It is worth noting that all three models, New Public Management, the steering perspective of New Administrative Law scholarship and the governance approach, are highly interdisciplinary in outlook and draw more than a little inspiration from economic theories and concepts. This essay therefore aims to describe and critically appraise the influence of economic theories on administrative jurisprudence in Germany and Switzerland.

7.2 Max Weber's Bureaucratic Authority

According to Niklas Luhmann, the steering element of administrative action can be differentiated into two forms: the instrumental programme and the conditional programme.[3] An instrumental programme specifies certain objectives of action and certain restrictions upon the choice of means, but ultimately leaves it to the agent to select the purposive measure within these restrictions.[4] By contrast, the conditional programme works according to the if-then formula; if certain conditions are met

[2]Critics speak of the "virus of formalism"; see Collins, p. 194.

[3]Luhmann, *Verwaltungswissenschaft*, pp. 87 et seqq.

[4]Rehbinder, margin no. 171.

(a *Tatbestand* or statutory definition), then a certain decision must be made.[5] Little discretion is left to the person responsible for applying the law.

This distinction between the conditional programme and the instrumental programme can be traced back to Max Weber's distinction between value rationality and instrumental rationality.[6]

> Examples of pure value-rational orientation would be the actions of persons who, regardless of possible cost to themselves, act to put into practice their convictions, of what seems to them to be required by duty, honor; the pursuit of beauty, a religious call, personal loyalty, or the importance of some "cause" no matter in what it consists. [. . .] Action is instrumentally rational (*zweckrational*) when the end, the means, and the secondary results are all rationally taken into account and weighed.[7]

In the ideal-typical case, the action of the instrumentally programmed administration is value rational, and the action of the conditionally programmed administration is instrumentally rational.[8] Accordingly, the instrumentally programmed administration is objective-oriented and conceives of itself as an organ of societal development. The conditionally-programmed administration, on the other hand, is characterized by procedural orientation. The executive organ known as "bureaucracy" evaluates its action according to whether it is a good means to an end that requires no further discussion. Separating the political decision-making (the "end") from the execution of this decision (the "means") makes the action of the conditionally programmed administration calculable.[9]

The concept of "bureaucracy" goes back to Max Weber, for whom it had not acquired any negative connotations. On the contrary; in his view it represents the most rational form in which authority is exercised:

> Experience tends universally to show that the purely bureaucratic type of administrative organization – that is, the monocratic variety – is, from a purely technical point of view, capable of attaining the highest degree of efficiency and is in this sense formally the most rational known means of exercising authority over human beings. It is superior to any other form in precision, in stability, in the stringency of its discipline, and in its reliability. It thus makes possible a particularly high degree of calculability of results for the heads of the organization and for those acting in relation to it. It is finally superior both in intensive efficiency and in the scope of its operations, and is formally capable of application to all kinds of administrative tasks.[10]

The ideal official is characterized by objectivity and impartiality. Accordingly, bureaucratic authority means

> [t]he dominance of a spirit of formalistic impersonality: "Sine ira et studio", without hatred or passion, and hence without affection or enthusiasm. The dominant norms are concepts

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[5] Luhmann, *Rechtssoziologie*, p. 227.

[6] Rehbinder, margin no. 171.

[7] Weber, p. 26.

[8] Rehbinder, margin no. 171; in more detail, Pankoke and Nokielski, pp. 11 et seqq.

[9] Rehbinder, margin no. 172.

[10] Weber, p. 223.

> of straightforward duty without regard to personal considerations. Everyone is subject to formal equality of treatment; that is, everyone in the same empirical situation. This is the spirit in which the ideal official conducts his office.[11]

Rationalization of the law means the generalization of legal rules and the formation and systematization of legal institutions[12]:

> Both lawmaking and lawfinding may be either rational or irrational. They are formally irrational when one applies in lawmaking or lawfinding means which cannot be controlled by the intellect, for instance when recourse is had to oracles or substitutes therefor. Lawmaking and lawfinding are substantively irrational on the other hand to the extent that decision is influenced by concrete factors of the particular case as evaluated upon an ethical, emotional, or political basis rather than by general norms.[13]

According to Weber, irrational elements in the administration of justice are, on the one hand, consulting oracles, and on the other hand, qadi justice or political justice which exhaust themselves in case-by-case decisions. Formally rational elements, in contrast, are reference to particular formal legal instruments, and the formation and systematization of abstract legal concepts and institutions. Material rationality means that legal decisions are justified with generalized ethical and political maxims or economic objectives.[14]

Weber believed that European law was more "rational" than the legal systems of other civilizations, being more highly differentiated: law was separated from other aspects of political activities and decision-making was not subject to constant political intervention. Legal rules were consciously fashioned and rulemaking was relatively free of direct interference from religious influences and other traditional values. Concrete legal decisions were based on the application of general rules and taken by a specialized status group of "lawyers".[15] This construct of bureaucratic rationalization is aimed at removing public power from the "arbitrariness" of the ruler and switching to it the mechanical execution of legal statutes, systematically shutting down the ambitions and motivations of the actors so that the bureaucratic operation can only "run on track" within the narrow corridor of its rule-defined functionality.[16]

The very concept of "bureaucracy" gives a terminological indication of the typical communication style: a "bureau" is an "agency of the written word", which is why bureaucracy can be defined as a form of authority exercised through paperwork, i.e. in the medium of rules, documents and filing procedures.[17] Since the holder of power must issue his orders as written instructions, he gives legal subjects the

[11] Weber, p. 225.

[12] Raiser, p. 854.

[13] Weber, p. 656.

[14] Raiser, p. 854.

[15] Trubek, p. 724.

[16] Pankoke and Nokielski, pp. 13 et seq.

[17] Pankoke and Nokielski, p. 14.

chance to orientate themselves within the framework of positively stipulated ends and to bind the ruler to the legality of his own regulations.[18]

In summary, it can be stated that the Weberian model of bureaucracy is oriented to rules, possesses a strict order of competence, hierarchical structures, a stringent division of labour and predetermined procedures, and is characteristically objective, impersonal, calculable, paperwork- and record-based, and conducted through sequential levels of review and grades of officialdom. On the one hand, this guarantees a high degree of legal certainty and state constitutionality, and especially, even-handed application of the law to all. On the other hand, this system also embodies those qualities nowadays referred to as "bureaucratic", namely the administration's lack of flexibility, the inadequacy of decisions in particular cases, and a high administrative load.[19]

In the nineteenth century, a transformation took place in European countries from the liberal constitutional state to the social state. As a consequence of this development, the limitations of the Weberian model of democracy were very soon encountered, and new models were developed in administrative science which increasingly took an interest in the impacts of state action and thus favoured a movement away from conditional programming towards instrumental programming of the administration.[20]

7.3 Economic Theory of Bureaucracy

In theoretical regards, quite an important contribution to the critique of Weber's model of bureaucracy was made by the economic theory of bureaucracy. Based on public-choice considerations, it overturned the notion that bureaucratic admin-

[18] Pankoke and Nokielski, p. 14.

[19] On this subject see Duncan Kennedy, 'The Disenchantment of Logically Formal Legal Rationality, or Max Weber's Sociology in the Genealogy of the Contemporary Mode of Western Legal Thought'; Julia Black, 'The Rise, Fall and Fate of Principles-based Regulation'; Enrico Peuker, *Bürokratie und Demokratie in Europa. Legitimität im Europäischen Verwaltungsverbund*, pp. 196 et seqq.

[20] For the developments in Switzerland see Markus Müller, *Verwaltungsrecht. Eigenheit und Herkunft* and Benjamin Schindler, '100 Jahre Verwaltungsrecht in der Schweiz'; for Germany see Michael Stolleis, *Geschichte des öffentlichen Rechts in Deutschland*, Vol. 4, pp. 404 et seqq.; id., 'Entwicklungsstufen des Verwaltungsrechts'; Ernst Forsthoff, *Lehrbuch des Verwaltungsrechts, Vol. 1: Allgemeiner Teil*, §§ 2 et seq.; for administrative law in Europe see Armin von Bogdandy, Sabino Cassese and Peter M. Huber (eds.), *Handbuch Ius Publicum Europaeum, Vol. III: Verwaltungsrecht in Europa: Grundlagen*, and *Vol. IV: Verwaltungsrecht in Europa: Wissenschaft*; Peter Arxer et al. (eds.), *Das Europäische Verwaltungsrecht in der Konsolidierungsphase. Systembildung, Disziplinierung, Internationalisierung*, Die Verwaltung, Beiheft 10; Jörg Philipp Terhechte (ed.), *Verwaltungsrecht der Europäischen Union*; Luis Moreno, 'Europeanisation, Mesogovernments and "Safety Nets"'; for international administrative law see Christoph Möllers, Andreas Voßkuhle and Christian Walter (eds.), *Internationales Verwaltungsrecht. Eine Analyse anhand von Referenzgebieten* and Oliver Lepsius, *Verwaltungsrecht unter dem Common Law*.

istrative agencies are politically neutral, without vested interests, and strive almost selflessly to accomplish the objectives defined by their political masters. Their main interests are vested in their own professional advancement, in a good salary, prestige and power. Through their involvement in defining problems and the instrumental shaping of political strategies, and in the course of execution itself, bureaucracy can also incorporate and realize its own interests.[21]

Fundamental contributions to the economic theory of bureaucracy go back to Gordon Tullock, Anthony Downs and William A. Niskanen. They were able to draw on groundwork by, among other precursors, C. Northcote Parkinson in "Parkinson's Law and Other Studies in Administration" (1957), in which he formulated the much-quoted Parkinson's Law[22]:

> Work expands so as to fill the time available for its completion.[23]

He presents the statement as a commonplace observation that has never previously been applied specifically to the field of public administration.[24] Taking the example of the British Navy, Parkinson illustrates that a bureaucracy grows continuously even when there is no increase in the volume of work to be done.[25]

Parkinson, however, was not the first to discuss the growth of state bureaucracy. Joseph A. Schumpeter, in his famous work "Capitalism, Socialism and Democracy" (1942), had already stated that the growth of bureaucracy was the one certain aspect of the future[26]:

> It grows everywhere, whatever the political method a nation may adopt. Its expansion is the one certain thing about our future.[27]

In 1888, Adolf Wagner had predicted this in his laws on the rising public spending ratio and the growth in state activity, a development that he regarded as essentially positive.[28]

Tullock generalized Parkinson's Law for bureaucracy in "The Politics of Bureaucracy" (1987), making reference to "bureaucratic imperialism" which functions as follows[29]:

> [T]he higher officials will actually encourage their inferiors to build up the size of the whole hierarchy since their own position, as well as that of their inferiors, will depend on the number of subordinates. Under such circumstances as these, the politician need be concerned with little else than the size of his "empire". He will attempt to increase this without limit.[30]

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[21] Hansmeyer, p. 76.

[22] Tullock, *Politics*, p. 134; Downs, *Inside Bureaucracy*, p. 16.

[23] Parkinson, p. 2.

[24] Parkinson, pp. 2 et seq.

[25] Parkinson, pp. 7 et seqq.

[26] Hood, p. 93.

[27] Schumpeter, p. 294.

[28] Towfigh and Petersen, p. 149.

[29] Tullock, *Politics*, p. 134.

[30] Tullock, *Politics*, p. 135.

Since the salary of departmental heads often depends on the number of subordinates, every line manager has an interest in constantly expanding his staff.[31] The problem is further exacerbated by the inertia of the administration: if the volume of work expands, it is relatively easy to increase staffing since this can be justified by the higher workload. However, if the workload subsequently reduces or certain tasks are dispensed with altogether, no one has an interest in cutting these jobs again because staff would have to be redeployed, retrained or even dismissed.

In his second major work, "Economic Hierarchies, Organizations and the Structure of Production" (1992), Tullock applies the insights from transaction cost theory, developed by Ronald Coase in his famous essay "The Nature of the Firm" (1937), to bureaucracy.[32] Even if a firm is hierarchically organized, the market ensures that inefficiencies are eliminated,[33] for if nothing is done about them, they reduce competitiveness and ultimately jeopardize the entire firm and the jobs associated with it.

This is not the case within the public administration: employees in state bureaucracies do not normally run any notable risk of losing their jobs, and seldom – if ever – have to bear more than minor negative consequences of their own activity (or inactivity).[34] Conversely, any efficiency-enhancing behaviour by members of the administration is normally punished rather than rewarded. For example, budget allocations are reduced if efficiency gains mean that less resources than budgeted were utilized during the previous period.[35] State bureaucracies lack the sanction mechanisms of the market, which is why Tullock believes it necessary to change the incentive structures.[36]

In "Inside Bureaucracy" (1966), Downs likewise describes a general expansionist tendency that is inherent to state bureaucracies:

> [B]ureaus have inherent tendencies to expand, regardless of whether or not there is any genuine need for more of their services.[37]

This he attributes to the fact that growth of an organization usually confers more power, income and prestige on its managers, thus incentivizing them to enlarge the organization.[38] According to Downs, the growth of an organization has various other advantages: first, enlargement and the usual greater degree of specialization that this implies, can give rise to economies of scale. Second, larger organizations have a better chance of survival than smaller organizations. Third, larger organizations are less easy to change and are therefore more resistant to external pressure.

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[31] Tullock, *Politics*, p. 134.

[32] Tullock, *Hierarchies*, pp. 11 et seqq.

[33] Rowley, p. xvii.

[34] Fritsch, p. 357.

[35] Thürmer, pp. 97 et seq.

[36] Tullock, *Politics*, pp. 165 et seqq.

[37] Downs, *Inside Bureaucracy*, p. 16.

[38] Downs, *Inside Bureaucracy*, p. 264.

Ultimately, very large organizations can offer their environment a certain stability, which reduces uncertainty.[39] To the above, Holzinger adds the interesting argument that the growth of an organization makes status improvements possible for some without making others worse off, which may help to avoid internal conflicts.[40] For all these reasons, an organization is interested in constant expansion of its human resources, its control over material resources and the enlargement of its original domains of competence.[41]

In "Bureaucracy and Representative Government" (1971), Niskanen characterizes a bureau as an organization that does not practise profit maximization and which is financed – at least in part – by regular financial donations from a sponsor organization.[42] In his model, he also assumes that the bureaucrats pursue individual objectives and do not strive solely for the good of society.[43] In the course of this, they seek to maximize the budget of their department:

> Bureaucrats maximize the total budget of their bureau during their tenure, subject to the constraint that the budget must be equal to or greater than the minimum total costs of supplying the output expected by the bureau's sponsor.[44]

Budget expansion in a certain domain can have a self-reinforcing effect: the higher the budget, the better the demands of the clientele can be served.[45] Accordingly, the latter will intensify their lobbying for further expansion of the budget for the relevant domain, and increase pressure on political decision-makers to further enlarge the administrative department in question so that it can serve its clientele better still. However, budget maximization is subject to the restriction that the costs of providing the good should not exceed its utility. The volume of state service provision will therefore regularly exceed the level that is allocatively optimal, but the pain threshold will be located at the point where the net utility of the good equals zero. Should this point be reached or if net utility tips over into negative territory, politicians will refuse their approval.[46]

The administrative officials can also play off their specialist competence against the politicians. This information asymmetry is evidence of a principal-agent relationship between politics and administration. The bureaucracy functions in the role of the agent, while politics acts as the principal. The administration is in a contractual relationship with policy, in which its mandate is to produce public or merit goods.[47] The problem of such a contractual relationship is that these can

[39] Downs, *Inside Bureaucracy*, pp. 17 et seq.

[40] Holzinger, p. 53.

[41] Hansmeyer, p. 76.

[42] Niskanen, *Bureaucracy*, p. 15.

[43] Niskanen, *Bureaucracy*, p. 36.

[44] Niskanen, *Bureaucracy*, p. 42.

[45] Fritsch, p. 358.

[46] Fritsch, pp. 359 et seq.

[47] Roschmann, pp. 37 et seq.

never be specified in such detail that the agent is left with no discretionary scope for decision-making and execution. That aside, the agent may be tempted to behave opportunistically to his own advantage, and can never be subject to total control since he is far closer to the matter in question.[48]

The principal-agent problem is particularly virulent for state bureaucracy, given that it holds a double monopoly position, with regard to both the state provision of services and the state monopoly on violence.[49] Moreover, its position in relation to the political sphere is further strengthened by the fact that officials normally remain in the same function over long periods of time – unless they are periodically required to stand for public re-election – whereas the political representatives move on relatively quickly, and are consequently dependent on the administration's experiential knowledge in order to safeguard the continuity of administrative processes.

If voters are also taken into consideration, as service recipients and taxpayers, this even gives rise to a two-phase principal-agent relationship[50]: in a first step, by casting their votes (in elections or also in direct referenda as the case may be), the voters entrust the politicians with representing their interests. Asymmetrical information in this case stems from the fact that voters are generally much less knowledgeable than politicians about the ways and means of state service provision. In a second step the politicians entrust the senior bureaucrats with the implementation of the measures. Again, these officials are far better informed about the provision of state services than the politicians.

Furthermore, a state that persistently intervenes in the economic process becomes the addressee for interest groups. As a possible consequence, productive competition between market providers can be suppressed to some extent by unproductive competition for political influence,[51] a phenomenon called "rent seeking" in the public-choice literature.

For its part, the public administration will likewise try to increase demand for its services by seeking to cooperate with those groups which derive utility from bureaucratic activity. Another popular strategy is to address publicity campaigns to the general public, emphasizing the benefits of bureaucratic activities whilst underplaying the costs.[52] On the service-provision side, moreover, there is a tendency to pursue highly visible and easily measurable outcomes (such as the building of facilities). Meanwhile, on the financing side, efforts are made to spread the costs as diffusely as possible (e.g. financing from general taxation).[53]

The structures described can result in a rising public budget coupled with inefficiencies and inadequate service provision. In this context, a negative correlation

[48] Roschmann, p. 38.

[49] Roschmann, p. 38.

[50] On this, see Fritsch, pp. 357 et seq.

[51] Gerken and Renner, p. 77.

[52] Holzinger, pp. 54 et seq.

[53] Holzinger, p. 55.

exists between the official's individual welfare and social welfare: The more successfully the public administration accomplishes its own interests, the greater the deviation of actual service-provision from the reference optimum of productive and allocative efficiency.[54]

The traditional instrument for tackling the principal-agent problem is the creation of control mechanisms. However, this not only generates additional costs but also introduces an additional agent, the controlling authority; this, in turn, should also be monitored, and so on. According to Downs, every attempt to exercise surveillance over a complex organization has the tendency to bring forth a new organization (examples being the "Bureau of the Budget" and the "General Account Office" in the USA).[55]

Niskanen recommends creating competition between different departments of the administration by allowing them to provide the same services, and letting the service recipients choose the provider themselves. Bureaucrats' incentives could also be modified in such a way that they are encouraged to minimize the budget, if their salaries were set to negatively correlate with the budget for a given output. Finally, the delivery of state services could be contracted out to private, profit-oriented institutions so that the state only retained responsibility for concluding and monitoring these contracts.[56]

7.4 New Public Management

The economic theory of bureaucracy can be seen as the essential element underpinning the development of "New Public Management" (NPM), which recommends that state administration work should be more oriented to management, results and performance as well as more autonomous.[57] Considerations focusing on the incentives for bureaucrats have given rise to instruments such as contract management, global budgets or benchmarking. For example, the aim of contract management is to make bureaucrats run the administration like an efficient, customer-oriented services company.[58]

New Public Management (NPM) is intended to transfer market principles, particularly cost-consciousness, efficiency-mindedness and customer-orientation, into the sphere of public administration. New Public Management is rooted in various administrative reform programmes that emerged in New Zealand, the Netherlands, Scandinavia and the USA in the 1980s and 1990s. Its theoretical foundations were

[54] Thürmer, p. 97.

[55] Downs, 'Nonmarket Decision Making', p. 443.

[56] Niskanen, 'Nonmarket Decision Making', pp. 304 et seq.

[57] Dehling and Schubert, p. 141.

[58] Towfigh and Petersen, p. 152.

provided by New Institutional Economics from the field of economics, and by modern management theory from the field of business administration.[59]

New Public Management is not a self-contained model of administrative organization and management, but is an umbrella term that brings together different lines of argument for administrative reform based on ideas from business administration and economics.[60] Corresponding administrative reform programmes go by very varied names: for example, "Reinventing Government" in the USA, "Agency Initiative" and "Next Steps" in the United Kingdom, "Contract Management" in the Netherlands or the "Free Commune Principle" in Scandinavia.[61]

In Germany, reference is made to the "New Steering Model" (*Neues Steuerungsmodell*), and in Switzerland the term "Impact-oriented Administration" (*Wirkungsorientierte Verwaltungsführung*) is widely used.[62] Most of the Swiss Cantons and the Federation, and also cities like Zurich and Bern, have carried out reform programmes based on New Public Management.

7.4.1 Core Elements of New Public Management

The characteristic elements of New Public Management can be described as follows:

Customer and Citizen Orientation

The administration has to elicit the needs of service recipients ("clients") as precisely as possible, and take its lead from the resulting information. Surveys are the means by which the wishes and needs of the population are ascertained.[63] The product involved is the unit of service rendered to the client (e.g. the vehicle test under the motor vehicle inspection system). Every product is circumscribed with a product definition, performance targets and performance indicators.[64]

Orientation to Efficiency and Effectiveness

State service provision has to be oriented to criteria of efficiency and effectiveness.[65] Effectiveness describes the extent to which the impacts of programmes or measures

[59] See Vogel, pp. 59 et seqq.
[60] Meyer, p. 7.
[61] Meyer, p. 7.
[62] Meyer, p. 7.
[63] Meyer, p. 9.
[64] Meyer, p. 8.
[65] Meyer, p. 9.

meet the envisaged targets of a policy (a target-actual comparison). Efficiency is understood to mean the relationship between the resources employed, such as finance or staff, and the resulting product (an input–output ratio).

Separating Strategic and Operative Competences

Parliament and the people only pass framework laws to set general objectives, i.e. they determine what needs to be done. The government is free to decide how it carries out these orders (final rather than conditional legislation). The strategic design of state activity should be left to the government, and the operative business to the administration.[66] Performance agreements (contracts) are concluded between the government or its departments and the lower administrative units (e.g. with a school leadership team).

Steering Output Rather than Input

The performance agreements define the output, i.e. they contain definitions of the quantitative and qualitative indicators for individual products and services, as well as their quantity and priority.[67] On the input side, the previously very detailed budget specifications for the running account are replaced by multi-year global budgets. This approach dispenses with various traditional budget principles, such as quantitative budget commitments and the prohibition on carrying credit forward, deferring credit or offsetting.[68]

Promoting Competition and Performance Incentives

Within the administration, services are accounted for at their actual costs. Furthermore, market elements are gradually introduced into the administration. Internal comparisons may be made between different public suppliers of a service, or the performance of a particular public task may be "contracted out" by an internal or external tendering procedure.[69] A system of incentives can also be used to raise the motivation, creativity and productivity of staff.[70] Incentives can be material (e.g. performance-related pay, bonuses) or non-material (e.g. the additional motivation of working autonomously, opportunities for professional advancement).

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[66] Meyer, p. 10.

[67] Delwing and Windlin, p. 186.

[68] Delwing and Windlin, p. 185.

[69] Rehbinder, margin no. 188.

[70] Meyer, p. 11.

Comprehensive Impact Assessment

In order to check whether the administration is fulfilling its contracts the performance indicators have to be reviewed.[71] An important evaluation method is benchmarking, in which the productivity of one's own administration is compared in terms of quality and deployment of resources with that of other administrations or private sector competitors. Cross-comparisons are used to analyze which competitor is the best, with a view to learning from them how the tasks in question can best be carried out.

7.4.2 Critique

Various concerns have been voiced about New Public Management; the following section engages specifically with the discussions that have taken place in Switzerland:

The State as an Enterprise

A fundamental objection is that the state – in sovereign areas, at least – cannot be run like a profit-making enterprise. Therefore criteria that are valid in the private sector, such as efficiency, cannot simply be applied to the state.[72] As consumers, private individuals meet their needs in accordance with their financial means. As citizens, however, in the social constitutional state they are entitled to public services – irrespective of their economic capacity – by virtue of the constitution and laws.

Rejection of the Constitutional State

In a constitutional state the entirety of state activity is subject to the principle of legality. The legality principle is the foremost priority of state action in a constitutional state. The requirement of the legality principle means that the state may only do what the law explicitly allows, in contrast to private individuals, who are permitted to do anything that the law does not explicitly prohibit. It is argued that the demand for greater efficiency and more flexible action by the administration tends to undermine the principle of legality and that of equality of rights.[73]

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[71] Meyer, p. 11.

[72] Rehbinder, margin no. 191.

[73] Delwing and Windlin, p. 196.

Erosion of Democracy

As a further weakness of NPM, it is claimed that if administrative units are constantly striving for additional flexibility, it almost inevitably entails a loss of political rights by parliament or even the people.[74] If the people and parliament were no longer permitted to intervene in operative matters, this would result in an erosion of democratic rights.[75] Another controversial issue is thrown up by altering the arrangement of competences between the legislative and the executive, namely the delegation of laws. This is overwhelmingly acknowledged in doctrine and legal rulings to be permissible but only under very restrictive conditions, the reason being that any delegation from the legislative to the executive constitutes a breach of the separation-of-powers principle; moreover, it may result in matters that are subject to referendum being placed beyond democratic influence.[76]

7.5 New Administrative Law Scholarship

In Germany, New Public Management (also known as the New Steering Model, "*Neues Steuerungsmodell*") was similarly discussed and to some extent implemented. However, the scholarly debate took a rather different course than in Switzerland, and interest turned more in the direction of "New Administrative Law scholarship".

Since the end of the 1980s, if not before, German administrative law has been in a phase of major upheaval, the causes of which are rooted in the crisis of traditional regulatory law and, at least in substantial areas of administrative jurisprudence, have led to a methodological reorientation.[77] On the one hand, deficits in execution were becoming apparent, particularly in environmental law; on the other hand, the administration was noted to be cooperating in diverse ways with companies and citizens in order to find jointly acceptable solutions to problems that arose.[78]

Consequently, a new direction was proclaimed within German administrative law theory, known as New Administrative Law scholarship, which is defined from the steering perspective and aims to give expression to the idea that administrative law does not merely supply a control programme but is essentially a behavioural programme.[79] Whilst administrative jurisprudence traditionally devoted its attention to regulatory law, the steering approach is envisaged as opening up the view to new forms of administrative action. Potential approaches may be the

[74] Meyer, p. 281.

[75] Delwing and Windlin, p. 191.

[76] Delwing and Windlin, p. 189.

[77] Voßkuhle, margin nos. 9 et seq.

[78] Voßkuhle, margin no. 10.

[79] Franzius, 'Steuerungsparadigma', p. 336.

targeted deployment of information, such as warnings, product recommendations and awards, but also the use of monetary incentives through deductions, subsidies or bond solutions, and various forms of conflict mediation and cooperation.[80]

7.5.1 Core Elements of New Administrative Law Scholarship

Steering Perspective

In a conscious broadening of perspective in comparison to the classic dogmatic approach, New Administrative Law scholarship conceives of itself as a steering discipline. This self-description contains the clear antithesis to the thesis that the law and the state are incapable of steering.[81] The consideration of administrative law from the steering perspective is based on the insight that the increasingly blurred boundaries and interconnected aspects of state action cannot be captured adequately in terms of dogmatics, which is tailored to sovereign activity.[82]

Impact Orientation

In order to achieve these ends, the focus of the traditional juristic method on legal acts is replaced with an impact-oriented perspective.[83] In this regard, New Administrative Law scholarship aims for an expressly scholarly, interdisciplinary orientation with a focus on legislation and legal policy. This means that it no longer wants to be confined to the sphere of administrative practice and administrative courts with the focus on particular case decisions. Instead it increasingly turns its attention to the programmatic level and to future law.[84] Consequently the judicial-protection perspective is augmented with an action perspective: the focal concern of scholarly interest becomes jurisprudence as a problem-solving and law-making discipline which informs action and decision-making.[85] At the same time, expression is given to the insight that the law not only produces impacts in line with the legislative intention but others which contradict that intention; for instance, if the law ignores the dynamic nature of society and bases statutory definitions on outdated expectations, or if competing economic or social imperatives are encountered in the process of applying the law.[86]

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[80] Rottmann, p. 208.

[81] Appel, pp. 241 et seq.

[82] Franzius, 'Steuerungsparadigma', p. 341.

[83] Franzius, 'Steuerungsparadigma', p. 340.

[84] Wahl, p. 89.

[85] Rottmann, p. 209.

[86] Scherzberg, p. 225.

Interdisciplinarity

The foundation and prerequisite for the steering approach is an "empirical context analysis" (*Realbereichsanalyse*), i.e. a broad and thorough investigation of legal facts and an interdisciplinary dialogue with other academic disciplines which deal with the subject of political steering.[87] Apart from the social sciences these will be economics disciplines first and foremost, and more specifically, newer research approaches such as New Institutional Economics or Environmental Economics.[88] The non-legal aspect of the law must be reflected in legislation as well as in the application and interpretation of the law, in order to ensure that the steering function of the law can truly take effect.[89]

7.5.2 Critique

Politicization of Administrative Law

Since New Administrative Law scholarship is a conscious effort to depart from the confines of individual cases and open up a more general steering perspective, the question arises as to which method it should adopt without venturing into the "political maze".[90] However, it should be borne in mind that even under the new approach, the mode of consideration is still selective in that the central distinction between law and non-law is preserved. Hence, the "research heuristics" of steering theory should not be played off against the normative perspective.[91] At the same time, one of the tasks of jurisprudence is to draw conclusions from the insights presented by economics and the social sciences, in all their empirical complexity, and to reduce these to forms of action that can be handled juristically, legitimized democratically, and realized by constitutionally acceptable means.[92] Thus, New Administrative Law scholarship opens itself up to the empirically-oriented adjacent disciplines without sacrificing the requirements of its own disciplinary identity.[93]

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[87] Rottmann, p. 208.

[88] Wahl, p. 90.

[89] Grzeszick, p. 106.

[90] Wahl, p. 91, alluding to a discussion paper by Niklas Luhmann bearing the title "*Im Irrgarten der Politik*" (In the political maze).

[91] Franzius, 'Steuerungsparadigma', p. 342.

[92] Kahl, p. 494.

[93] Rottmann, p. 208.

Overloading of the "Ought" Perspective

Another criticism concerns a possible overloading of the "ought" perspective of law with an "is" perspective that ostensibly has nothing to do with law.[94] For that reason, "filtering procedures" are still necessary, with the outcome that not all material from the social sciences can be turned to the purposes of legal dogmatics.[95] In other words, the law has to process various views of reality, i.e. they must be captured and channelled somehow; this requires the law to be open to empirical data, at least interpretatively, e.g. when it comes to the interpretation of indeterminate legal concepts.[96] Specifically, empirical context analysis must not be equated with the jurists' "normative context analysis" (*Normbereichsanalyse*) Although both of them make reference to social, political, economic, cultural, technological or ecological slices of reality, the role of normative context analysis is to appraise the objective arguments from the actual context in which the legal regulation is intended to be effective, in the course of concretizing the legal norm, and to ascribe empirical context analysis its place in accordance with the legal norms.[97]

Proviso of Valid Law

Translation of the steering theory perspective into valid law is always covered by the proviso that the legal rules of the state constitution, namely basic rights and the formalized democratic requirements for the enactment of law as a steering instrument, must be respected.[98] The task of administrative jurisprudence is to relate the classic dogmatic understanding to the steering-theory approach, i.e. the legal-act focus and the behavioural perspective, as productively as possible.[99] Of course, the consideration of legal norms from the administrative perspective does not mean that the judicial-protection perspective is dispensable.[100] While the steering approach can usefully complement and enhance the normative legal perspective, it cannot claim legal normative validity outside of existing laws, but only draw attention to an administrative policy "ought" out of legal necessity.[101]

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[94] Franzius, 'Steuerungsparadigma', p. 342.
[95] Kahl, p. 494.
[96] Kahl, p. 494.
[97] Rottmann, p. 215.
[98] Rottmann, p. 214.
[99] Appel, p. 255.
[100] Rottmann, p. 209.
[101] Rottmann, p. 214.

7.6 The Governance Approach

In the meantime, the popularity of New Public Management in Switzerland has passed its prime, and other models such as "governance" have come to the fore.[102] Similarly in Germany, there are signs that the steering approach will be superseded by another concept that is more internationally compatible.[103] The problems of political steering, i.e. the inadequacies of the public sector in implementing political objectives, are no longer ascribed to the state ("state failure") or to the policy sphere or the bureaucracy ("political and bureaucratic failure") but to society itself. It is then discussed in terms of "societal failure".[104]

The governance concept originates from the transaction cost theory of New Institutional Economics. Oliver E. Williams, in his essay "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) juxtaposed the market and the hierarchy as two coordination mechanisms, in which transaction costs are the arbiter of which mechanism will be more efficient in which case.[105] Further coordination mechanisms which could be observed in practice were soon added – for instance, clans, associations and networks – so that governance came to encompass all the key modes of coordinating action.[106]

With this extension of the concept to all forms of coordination, above and beyond market and hierarchy, the concept was no longer bound to the domain of economics and was increasingly also adopted by political science.[107] This was not without repercussions for administrative jurisprudence, in which governance was advancing as a strategy for reform which refines the models of New Public Management by taking account of the administration's external as well as its internal relationships.[108] The governance concept not only triumphed in the academic sphere but also became a slogan of state and administration modernizers.[109] The governance approach addresses many phenomena which have been observable for much longer as cooperative and informal state and administrative action, and brings them to one common denominator.[110]

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[102] Engi, 'Neue Verwaltungsrechtswissenschaft', pp. 158 et seq.

[103] Appel, p. 245.

[104] Jann, p. 32.

[105] Williamson, pp. 247 et seqq.

[106] Mayntz, 'Governance Theory', p. 14.

[107] Mayntz, 'Governance Theory', p. 15.

[108] Engi, 'Governance', p. 575.

[109] Jann, p. 21.

[110] Engi, 'Governance', p. 577.

7.6.1 Core Elements of Governance

The governance concept is hard to define precisely, as there is no single unified understanding of the concept. In the broader sense, governance refers to the regulation of collective concerns in any given form.[111] Often the concept is normatively-laden, as expressed in the phrase "good governance", which the World Bank – following the traditional doctrine of the prudent constitution of state and society – understands as encompassing political participation, social pluralism, rule of law, free markets and a good administration.[112]

In parallel with this comprehensive concept, a narrower variant developed in administrative science. Unlike governance used as a collective term for all forms of social coordination of action, the narrower concept serves to emphasize the contrast between hierarchical steering and cooperative regulation. Governance was thus cast as a counter-concept to hierarchical steering, and signifies a fundamentally non-hierarchical style of government in which private actors participate in the formulation and implementation of policy.[113] Governance in this narrower sense is characterized as follows:

Lack of Centralized Steering

Governance implies the lack of hierarchical, centralized steering, i.e. the absence of an instance onto which authority can be projected.[114] Consequently, it refers to modes of action which are not unilaterally dictated by the state, but decided upon by the state and private entities on fundamentally equal terms.[115] In other words, prominence is given not to the actors but to the search for regulatory structures, within which state and non-state actors work together on different levels to regulate collective concerns and problems.[116] Involving private actors in addressing problems is intended to motivate and activate them instead of imposing "top down" steering and state services.[117] Public-private partnerships (PPPs) are seen as a central mode for realizing this sharing of responsibility.[118] Consequently the boundary between "public" and "private" starts to become more fluid.[119]

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[111] Engi, 'Governance', p. 576.

[112] Kersten, p. 45.

[113] Mayntz, 'Governance Theory', p. 15.

[114] Engi, 'Governance', p. 576.

[115] Engi, 'Governance', p. 576.

[116] Appel, p. 245.

[117] Jann, p. 33.

[118] Voßkuhle, margin no. 63.

[119] Franzius, 'Governance', p. 191.

Networks in Place of Hierarchy

Some areas of public administration can no longer be reflected by steering theory, because in a few sectors of public administration the reality has overtaken the steering model. Local, regional, state, European, transnational and international, private and civil society actors act, in many contexts, within network structures which permit no clear distinction between the subject and the object of steering.[120] In network structures the question, "Who is actually steering whom?" simultaneously indicates both the limitations of steering model and the necessity of the governance perspective.[121] Also in keeping with this is the interpretation of governance as interaction and communication. For the objective is no longer a unilateral decision from a legitimized authority, but for the people affected to work together to find a solution.[122]

Combination of Different Modes of Action

Whereas New Public Management focused primarily on the market and advocated correct incentives, neither the hierarchy nor the market are central to governance, but rather the network and the intelligent linkage of different modes of action.[123] Such a policy is characterized by the conscious organization and management of networks and interactions between state, economy, civil society and individuals.[124] It is closely allied to the tendency to move away from the "service state" (*Leistungsstaat*) towards the "ensuring state" (*Gewährleistungsstaat*, also known as the "enabling state").[125] In a nutshell, government in line with governance principles can be described as a combination of less state with more politics.[126]

Institutionalist Mode of Thought

The governance perspective slips seamlessly into an institutionalist mode of thought since the focus is not on intervention, i.e. the steering behaviour of actors, but on the regulatory structure (however it has come about) and its effects on the behaviour of actors subject to it.[127] The internal view of the state is thereby supplemented

[120] Kersten, p. 46.
[121] Trute, Denkhaus and Kühlers, p. 461.
[122] Engi, 'Governance', p. 577.
[123] Jann, p. 32.
[124] Jann, p. 37.
[125] Jann, pp. 35 et seq.
[126] Jann, p. 37.
[127] Mayntz, 'Governance Theory', p. 14.

with an external perspective: The focus of the analysis is no longer aimed so much at the individual public agency but at the combination and coordination of public, private and civil society actors.[128] Governance therefore denotes not only the shift in perspective from steering towards cooperative regulations, but also the broadening of the actor-centred perspective that results from this institutionalist dimension.[129]

Dynamic Aspect

Governance reflects that statehood is permanently in flux, and helps to concretize and operationalize this. Simultaneously this opens up a dynamic perspective, with the result that governance is better than traditional approaches at describing and explaining change processes.[130]

7.6.2 Critique

Shift in Perspective

Being at least in part a reaction to changes in the politically-relevant reality, such as cooperative administrative action, the shift in perspective from steering to governance certainly appears to take a more realistic view of these developments. However, the drawback is that the altered perspective makes it more difficult to deal with questions that are central to the steering-theory approach.[131] Loss of the clear separation between the subject and object of steering makes it impossible to address the steering problematique systematically and to analyze the gaping divergence between steering need and steering capability with sufficient theoretical rigour. By ceasing to differentiate between the subject and object of steering, governance theory does away with the crucial point of departure for analytical treatment of these questions.[132] Therefore the governance approach can only complement, but not replace, the steering approach, at least as long as large parts of administrative law are still based on the traditional separation of the subject and object of steering.

[128] Jann, p. 32.

[129] Schuppert, p. 45.

[130] Schuppert, pp. 45 et seq.

[131] Mayntz, 'Governance Theory', p. 17.

[132] Mayntz, 'Governance Theory', p. 17.

Dismissal of Actors

Another problematic issue for jurisprudence proves to be the institutionalist mode of thought, the reason being that state and administrative jurisprudence, like legal science in general, is an actors' discipline when it focuses on actions and resolves associated conflicts of interest.[133] Proposed interdisciplinary theories which screen out the actor are therefore not compatible with jurisprudence, as is demonstrated by the example of system theory, which is ultimately ineffective in jurisprudence or at least its reception has failed to progress beyond a reduced set-piece version. Hence, governance can only become established as a key concept in administrative jurisprudence if it does not dismiss the actor.[134]

Privileging of Particular Interests

At first glance, the participatory approach of governance promises the involvement of all affected population groups on equal terms. De facto, however, very few citizens have the time and material resources to allow constant participation in state matters, which is why even the most elaborate forms of political participation can be affected by major social distortions.[135] In particular, there is a risk of privileged interests dominating the negotiations. If, in addition, particularly influential negotiation partners number among the main producers of the problems, whilst those negatively affected have very little influence, it is questionable whether any problem-solving will be effective.[136]

Dismantling of Democratic Control

A further problem resides in the dismantling of democratic control. It was not by chance that the modern constitutional state concentrated generally binding power in its organs and subjected it to democratic control. The governance approach harbours the risk that the power may leak out of these controlled arenas into less transparent realms.[137] Therefore the questions arise as to when state actors may engage in networks, if at all; when they must leave them again; and how they can still fulfil their constitutional-law commitments within networks.[138]

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[133] Kersten, p. 49.

[134] Kersten, p. 49.

[135] Engi, 'Governance', p. 581.

[136] Mayntz, 'Staat', p. 45.

[137] Engi, 'Governance', p. 587.

[138] Kersten, p. 50.

7.7 Conclusion

In modern European welfare states, state action not only has to be constitutionally correct as in the liberal state, but must also be conducive to establishing distributive justice. Furthermore, in view of increasingly tight state finances, the efficiency of state activities becomes a requirement of ever-increasing importance. Even if justice and efficiency are frequently in conflict with each other,[139] they nevertheless have one thing in common: the instrumental and consequential orientation.[140] This entails greater instrumental programming of administrative law, in contrast to the traditional approach of conditional programming as described by the Weberian model of bureaucracy that was mirrored in reality in the liberal constitutional state. Instrumental programming, moreover, and the administration's concomitant responsibility for consequences, call for insights from other disciplines in order to be able to predict and evaluate the real consequences of state action. It is therefore no coincidence that new theories of administrative law – New Public Management, New Administrative Law scholarship, and governance – have a pronounced interdisciplinary tendency and draw quite substantially on concepts and insights from the field of economics. At the same time a change in administrative law culture can be observed: modern administrative law governs value pluralism by the formalization of interactions between players instead of the formalization of values, and traditional hierarchical regulation is supplemented by cooperative control structures such as networks. This is how modern administrative law tries to provide a framework for the various ways of life and opinions present in a multicultural and globalized society.

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[139] On this subject area see Klaus Mathis, *Efficiency Instead of Justice? Searching for the Philosophical Foundations of the Economic Analysis of Law*.

[140] On the consequential orientation of law in general, see Klaus Mathis, 'Consequentialism in Law'.

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Part III
The Limits of Legal Transplants

Chapter 8
The "Hand Rule" as a Standard of Care in Swiss Tort Law?

Balz Hammer and Sandra Duss

Abstract The "Hand rule" – named after US Federal Judge Learned Hand, its originator – is familiar in the literature of Economic Analysis of Law as the first attempt to define the standard of care when determining negligence, and hence ultimately liability, by means of a cost-benefit analysis. According to the rule, a person acts negligently if the expected value of some harm caused by that person is greater than the cost of avoiding it. Proponents of the Hand rule see it as the basis for the most efficient possible regulation of tort law, since in bilateral incidents of harm or accidents it sets the right incentives for both the injurer and the victim to take precautions as long as the costs are proportionate, and thus promotes the maximization of social welfare. The objection to this imposition from a traditional juristic viewpoint is that tort law's main function is to bring about corrective justice between the affected parties rather than to achieve welfare-maximizing outcomes of any kind. The present essay attempts to mediate between these conflicting viewpoints by setting out the possibilities and limitations of any application of the Hand rule in Swiss tort law.

8.1 Introduction

An economic constant states that resources are scarce but the needs of individuals are diverse and unlimited. Deriving from this insight, the central question of economics concerns the *optimum allocation of resources*, i.e. the question as to how

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scarce resources can be distributed in order to satisfy present needs as efficiently as possible. If this works, then ultimately the whole of society will see its wealth maximized.[1]

The Economic Analysis of Law attempts to apply these underlying principles to the norms and institutions of the legal system. Insights are thereby gained which may *heighten the efficiency* both of law-making and the application of law. Among the most important areas of application for this modern research approach – apart from criminal law – is *tort law*.[2] Its primary function from an economic viewpoint consists in minimizing the costs of accidents for society as a whole. While US tort law has led the way in reflecting these kinds of efficiency considerations, in continental Europe and Switzerland in particular they have been perceived rather sceptically until now, particularly given the emphasis of the Swiss tort regime on traditional considerations of justice.[3] However, since we live in a free market economy, the courts even in this country have no choice but to pay greater heed to economic considerations in their decision-making on the assessment of a tort case.

In this connection the judgement of the Swiss Federal Supreme Court on the so-called "Bern window-plunge case" caused a major furore.[4] At Bern university hospital a patient was diagnosed with delirium[5] following a heart operation. Since it is well known that delirium patients have jumped out of windows on many occasions the windows and balcony doors of the hospital room were bolted shut as a precaution. At the same time, the patient was closely supervised. Nevertheless, the improbable occurred: the patient left his room in the night and plunged to his death from the balcony of the neighbouring room. His bereaved relatives proceeded to lodge a claim against the hospital for damages and satisfaction, on the grounds that it had breached its medical duty of care.

The Swiss Federal Supreme Court now had to determine what measures had been reasonable in order to comply with the medical duty of care. It initially found

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[1]For a detailed presentation of Richard Posner's theory of wealth maximization, see Mathis, *Efficiency*, pp. 143 et seqq.

[2]Historically, tort law was one of the starting points of Economic Analysis of Law and is now one of the best researched areas of this legal theoretical discipline. Fundamental contributions to this development were made by the works of Guido Calabresi, *The Costs of Accidents*, and John P. Brown, 'Toward an Economic Theory of Liability'.

[3]For instance Honsell, § 1 N 73, views the prevalence of the idea of compensation as an instance of great cultural progress which may not be undone for any reason.

[4]BGE 130 I 337. This case is especially controversial since the Federal Supreme Court overruled the Canton of Bern administrative court's decision and referred the case back to the lower court. In its new judgement, however, the lower court did not adhere to the Federal Supreme Court's dismissal, whereupon the complainants took their case to the Federal Supreme Court a second time. In BGer 4P.244/2005 of February 6, 2006, the Federal Supreme Court also overturned the administrative court's second ruling and accepted the appeal.

[5]A delirium is understood to mean an etiologically unspecific organic brain syndrome characterized by disturbances of consciousness, attention, perception, thinking, cognition, memory, psychomotor and emotional functions.

that a night-sitter stationed outside the patient's room through the night could have prevented the fatal incident. However, it found that this measure was only required if it was financially reasonable for the hospital, i.e. *cost-effective*. To ascertain the *financial reasonableness* of the intervention, the Federal Supreme Court put forward the following cost-benefit considerations. A night-sitter would cost the hospital a maximum of CHF 30 per hour. On past experience, the post-operative confusion of the delirium patient would last for about a week. Working on the basis of 8 h per night, then a 1-week night-sitter would cost a total of CHF 1,680 per delirium case. These costs – according to the Federal Supreme Court – would appear financially reasonable in comparison to the far higher costs of the heart operation undergone by this patient. For that reason the hospital was found to have breached its duty of care and was held liable by the court.[6]

Obviously the Swiss Federal Supreme Court overlooked the so-called *"Number Needed to Treat" question*[7] since it based its calculations only on *total* costs and not on the *marginal* costs of harm avoidance. Naturally the costs of CHF 1,680 to assign a night-sitter for 1 week, which could have prevented the harmful incident, were insignificantly low in comparison to the harm that occurred, except that the Federal Supreme Court disregarded what a highly improbable case this was: according to experts, only one case in a million would culminate in the death plunge of a delirium patient through the window of the neighbouring room, which means that if the clinic spends CHF 1,680 on additional precautionary measures on one million occasions, precisely one human life will be saved. And if the correctly calculated probability that such a harmful incident will occur (1:1,000,000) is set in relation to the costs of hiring a night-sitter for 1 week (CHF 1,680), the resulting marginal costs amount to approx. CHF 1.7 billion per human life saved.[8] Such high costs are by no means within reasonable financial bounds; therefore no breach of the duty of care should be found and the lawsuit of the bereaved relatives should have been dismissed.[9]

As these arguments show, the Swiss Federal Supreme Court has committed a critical fallacy in this respect: when it comes to the question of whether a precautionary measure is financially reasonable and hence required *ex ante*, the costs of it must not be measured against the actual costs of the harm that occurred, but only against the *expected costs* of the harm, which is calculated by multiplying the probability of the occurrence of harm by the potential magnitude of that harm. Anything else would not be cost-effective and therefore not generalizable to similar situations. US courts avoid this fallacy by regularly making use of the Hand rule as a measure of care when assessing tort cases.

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[6] BGer 4P.244/2005, E. 4.

[7] In healthcare, the "Number Needed to Treat" (NNT) refers to the number of patients whom it would be necessary to treat in order to avoid one additional bad outcome – for example, in cancer treatment, the death of one patient.

[8] These figures are taken from the calculations of the lower court. See BGer 4P.244/2005, E. 4.1.

[9] This was the decision of the lower court, whose judgement was overruled by the Federal Supreme Court. On this, see BGer 4P.244/2005, E. 4.1 and 5. Criticism of the Federal Supreme Court's ruling are voiced e.g. by Kuhn, pp. 1015 et seqq. and Seiler, pp. 148 et seqq.

The aim of the present analysis is to discuss the Hand rule as a model, largely unknown in Swiss legal circles, for determining the reasonable level of care, and to point out its potential applications. To this end, after this introductory section, the essay begins with a survey of the functions of tort law and the incentive effects of the basic liability rules (Sect. 8.2). Accordingly, the concept and meaning of the Hand rule will be clarified, starting with a look at its historical development and examining the elements of the formula and its scope of application (Sect. 8.3), before a critical appraisal of the Hand rule can be undertaken (Sect. 8.4). Proceeding to practical case examples, the next step is to examine the extent to which incipient Hand rule approaches can already be identified in Swiss tort law today, and which potential applications of the rule exist in Switzerland (Sect. 8.5). Finally, the findings will be summarized in a conclusion (Sect. 8.6).

8.2 Overview of the Economic Analysis of Tort Law

In contrast to contract law, tort law regulates the legal consequence between non-contracting parties who have harmed each other in any form.[10] Since legal norms of tort law define binding standards for the level of due care or extent of precautionary measures that a potential injurer should take towards other legal subjects, they exert a direct influence on behaviour.[11] Specifically from the economic perspective, however, it is desirable if this standard of care not only results in an equitable solution between the parties but also leads to a socially efficient outcome.[12] The following section will begin with a comparison of the functions of tort law from a legal and an economic perspective, as a basis upon which the optimal degree of precautions can be determined and the basic liability rules can be presented individually.

8.2.1 Functions of Tort Law from a Legal and an Economic Perspective

From a legal point of view, tort law serves to protect individual legal goods and – under certain conditions[13] – economic assets, by regulating the *compensation of*

[10] When the parties concerned are not in any contractual relationship with one another which would regulate the consequences of a harmful event, so that the harmful event or accident itself instigates the legal relationship between them, this is referred to in economics as an *involuntary transaction*. Brown, 'Liability Rules', pp. 34 et seq.

[11] Brown, 'Liability Rules', p. 35.

[12] Mathis, *Efficiency*, p. 78.

[13] Under Swiss law, compensation for pure economic losses ("*reine Vermögensschäden*") demands a breach of a protection norm, i.e. the violation of a behavioural norm, the purpose of which is to protect against such forms of harm. Bärtschi, p. 119.

loss between parties: the injurer who harms another party by violating a duty of conduct or causes immaterial harm must reimburse the injured party or make it good.[14] This *deontological* approach to justification in tort law is broadly concerned with adherence to certain principles – such as justice, fairness, reciprocity or responsibility – for the protection of individual rights.[15] The purpose is ultimately to correct the injustice between the parties caused by the instance of harm, and restore a lawful state of affairs.

From an economic perspective, on the other hand, tort law represents an instrument for the *achievement of collective ends* – such as maximizing social utility or increasing efficiency. It serves merely as a means to an end.[16] According to this *consequentialist* approach, essentially three different functions of tort law can be named: the internalization of negative externalities,[17] the spreading of losses,[18] and the deterrence or preventive function; economists place the overall emphasis on the latter. Accordingly, tort law functions as a deterrence mechanism against economically inefficient behaviour. The intention is not, however, to prevent accidents per se but solely to *minimize the social costs of accidents*, i.e. both the expected accident costs (expected damages) and the necessary costs of precautions to prevent accidents (avoidance costs) should be kept as low as possible.[19] As will be shown below, these two cost elements are pivotal to the formulation of the Hand rule.[20]

The main difference between these two approaches is that, for jurists, *the idea of compensation or justice* is the priority, whereas economists are oriented to the *efficiency paradigm*.[21] For this reason, jurists see the main task of tort law as to regulate the general compensation of a harm that has already occurred. Economists,

[14] Bärtschi, p. 131; Rey, N 12.

[15] Coleman, pp. 13 et seq.; Perry, p. 67.

[16] Hartmann, p. 64.

[17] The definitive criterion is the *principle of causation*, i.e. the person who caused the harm is liable for it. Negative externalities (costs) incurred by B but caused by A are passed on from B to A. A is liable towards B for the harm caused.

[18] The concern here is to minimize the repercussions of a certain instance of harm for the whole of society. The aim therefore is to spread the loss suffered by an individual or the resultant costs as well as possible across the whole of society. Calabresi, pp. 39 et seqq. This spreading function is largely fulfilled by the insurance market (e.g. obligatory liability insurance). Perry, p. 77.

[19] In this context Guido Calabresi developed the argumentational device of the "cheapest cost avoider", whereby the person who should be obliged to prevent the harm or pay compensation is whoever can avoid the harm at the lowest cost; Calabresi, pp. 136 et seqq. This model is intended to resolve cases of reciprocal harm, when the avoidance of a disadvantage to one party irrefutably imposes a disadvantage on the other party, i.e. if either the injurer, the victim, or a third party alone can prevent the harmful event. Gerner-Beuerle, pp. 17 et seq.; Schäfer and Müller-Langer, pp. 16 et seq. Based on this reasoning, it is then possible to derive the various liability rules, each with their own efficient scope of application. On this, see Sect. 8.2.3 below.

[20] On this, see Sect. 8.3.2 below. An overview of the individual economic theories behind these functions of tort law is provided in Perry, pp. 68 et seqq.

[21] Mathis, *Efficiency*, p. 78.

in contrast, understand tort law as an instrument for influencing the future behaviour of potential injurers and injured parties. Hence, the viewpoint from which these two camps assess an instance of harm also differs in temporal terms: the jurist takes an *ex post* and the economist an *ex ante* perspective, so from the traditional juristic point of view tort law is ascribed a *compensatory* function, whereas from an economic viewpoint its primary function is *preventive*.[22] Finally, seen through the lens of law and economics, both functions need to be realized as evenly as possible.[23]

8.2.2 *The Optimum Degree of Precautions to Minimize the Social Costs of Accidents*

As we have seen, from the viewpoint of Economic Analysis of Law, tort law is ascribed a preventive effect, i.e. by means of an efficient incentive structure the social costs of accidents will be minimized, ultimately maximizing social welfare. A key factor in reducing the cost of accidents is investment in precautions, since the purpose of these is to prevent harmful incidents as far as possible. However, because of the usually high costs of precautionary measures, for welfare-economic reasons these *costs of avoidance* need to be weighed against the *expected costs of damages* in order to determine the optimum, i.e. socially efficient, relationship between the two cost items. For the sake of cost efficiency, then, additional precautionary measures must only be taken as long as the marginal harm they are likely to prevent is at least as great as the marginal cost to be spent on avoiding that amount of marginal harm. Consequently, the social optimum of precautionary measures can be stated as:

$$marginal\ \ cost = marginal\ \ harm.$$[24]

On an individual level this means that the potential injurer or injured party should invest in precautions up to the point that any additional unit of costs spent would reduce the expected costs of any harm by at least one cost unit.[25] The question now is what liability rule sets the *right incentives* for individuals, so that they take the optimal level of precautions and ultimately contribute to minimizing the social costs of harm?

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[22] Mathis, *Efficiency*, p. 69. From a juristic viewpoint, preventing harm is only a secondary purpose or side effect of tort law, at the most. On the situation in Swiss tort law see e.g. Bärtschi, p. 131; Rey, N 14 et seqq.

[23] Mathis, *Efficiency*, p. 79.

[24] Cooter and Ulen, pp. 201; Mathis, *Efficiency*, pp. 70 et seq.

[25] Brown, 'Liability Rules', p. 36.

8.2.3 Basic Liability Rules and Their Incentive Effect

If tort law is to produce an incentive for the individual to behave in a socially efficient manner, then the decisive factor is whether, based on the outset situation prior to the incident, the injurer alone, the victim alone, or both parties at once are in a position to take precautions. Depending on the scenario different liability rules will set the right incentives for the affected parties to realize cost-efficient precautions. Below, the three basic liability rules will briefly be discussed and the efficient scope of application of each will be outlined in turn.

No Liability

The rule of no liability goes back to the principle of "*casum sentit dominus*" in Roman law and states that victims themselves must bear the cost of the harm suffered, for which reason it is also called victim liability.[26] Since the potential victim is not permitted to claim damages from anyone in the event of harm, he has an incentive to take the socially efficient or optimum level of precautions, i.e. he invests in precautions as long as the costs do not exceed the expected value of injury. Therefore no liability is always the socially efficient liability rule where the victim alone can take precautions to prevent the harm occurring (so-called *nonlateral accidents*).[27]

Strict Liability

The counterpart to the rule of no liability is strict liability, which involves a *materially appropriate distribution of risk*. In this case it is not the victim but whoever derives an economic benefit from a dangerous situation that bears the risk of any harm caused by third parties.[28] The potential injurer is therefore made liable both for the costs of precautions and the costs of any harm.[29] This gives him an incentive to take the optimum level of precautions because otherwise he has to compensate the victim in full.[30] Consequently, strict liability is always the socially efficient liability rule where only the potential injurer can prevent the harm occurring (so-called *unilateral accidents*).[31]

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[26] Brown, 'Liability Rules', p. 38; Nell, Hofmann and Buhné, p. 853; on the significance of this principle in Swiss law see Rey, N 18 et seqq.

[27] Mathis, *Efficiency*, pp. 72 et seqq.

[28] Rey, N 95. A fundamental presentation of strict liability from the perspective of Economic Analysis of Law is found in Richard A. Epstein, 'A Theory of Strict Liability'.

[29] Mathis, *Efficiency*, p. 73; Nell, Hofmann and Buhné, p. 853.

[30] Brown, 'Liability Rules', p. 38; Schäfer and Müller-Langer, p. 10.

[31] Cooter and Ulen, p. 225; Mathis, *Efficiency*, p. 74.

Negligence Liability

Under negligence liability, the individual who omitted to take *due care* – i.e. a particular level of precautions – is liable to pay compensation for damages. If a harmful event occurs, the injurer is not liable per se unless he acted carelessly in the sense mentioned above.[32] In economic terms he therefore has an incentive to take the optimum level of precautions. If he does so, then conversely the victim has an incentive to take the precautions that are optimal from his point of view, otherwise he has to bear the cost of is his own harm himself.[33] Thus it is clear that this liability rule leads to the socially efficient outcome in those cases where both injurer and victim can take precautions to avoid possible harm (so-called *bilateral accidents*), since both parties are set the right incentives to take the optimum degree of care and thus prevent harm if possible.[34]

The question now is how the requisite degree of care or precautions can be determined in a concrete case, i.e. the question of the *standard of care for determining negligence*. From a legal viewpoint, negligence amounts to omission of the due care required by the given circumstances. This omission is ascertained by comparing the injurer's actual behaviour with the hypothetical behaviour of an average careful person ("*diligens pater familias*") in the injurer's situation. Any negative deviation from this average behaviour is deemed to be careless and hence treated as negligent.[35] The standard of care is thus the behaviour of an average reasonable person in the same situation.[36] In economic terms, on the other hand, negligence is understood as careless behaviour if the costs of the necessary precautions are lower than the expected damages.[37] According to this understanding, recourse is taken to the well-known Hand rule, which will be dealt with in detail in the following section, to determine the standard of care for negligence.

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[32]Brown, 'Liability Rules', p. 38. According to US law, negligence liability can be further divided into different subtypes, each associated with different legal consequences. In *simple negligence* the injurer is held liable for the full extent of the harm caused, irrespective of the victim's behaviour. Under the *negligence with a defense of contributory negligence* rule, the injurer can discharge himself from liability if he proves that the victim also acted negligently. Finally, under *comparative negligence* the costs of the harm are split between the parties proportionally, depending on the contribution of their negligent behaviour to the harmful event. Cooter and Ulen, pp. 208 et seqq.; Schäfer and Müller-Langer, pp. 17 et seqq.

[33]Guttel, p. 1396. For a detailed economic analysis of the law of negligence liability, see Richard A. Posner, 'A Theory of Negligence'.

[34]For the derivation of this result see Cooter and Ulen, pp. 205 et seqq.; Mathis, *Efficiency*, pp. 75 et seq.

[35]Rey, N 843 et seq.

[36]Fletcher, *Concepts*, p. 189.

[37]Perry, p. 70.

8.3 The Hand Rule as a Standard of Care

Long before the Economic Analysis of Law became influential in the US, the Federal Judge *Billings Learned Hand* (1872–1961) developed a standard of due care based on cost-benefit considerations for use in the assessment of negligence. This formula, named the Hand rule[38] after its originator, is still used today in many tort cases heard in US courts in order to settle questions of negligence.[39] The nascence of the rule can be dated to the civil trial *United States v. Carroll Towing Co.*,[40] on which Judge Hand had to pass judgement in 1947. The legal dispute related to a shipping accident that had occurred on January 4, 1944 in the New York harbour. There follows a chronological account of the most important facts of this case, after which the formulation of the Hand rule is described and its scope of application outlined.

8.3.1 The Origin of the Hand Rule: United States v. Carroll Towing Co.

The *Pennsylvania Railroad Co.* had chartered the barge "Anna C." from the *Conners Marine Co.* In addition, the lease contract included the services of a barge attendant, also to be supplied by the *Conners Marine Co.* On January 2, 1944 the "Anna C." was loaded with a cargo by the *United States* and moored 2 days later at Pier 52 of the North River. On this day, January 4, 1944, the steam tug "Joseph F. Carroll" owned by the *Carroll Towing Co.*, was sent to the Public Pier, which was directly adjacent to Pier 52 to the north, in order to tug another barge from that pier. The personnel on board the "Joseph F. Carroll" included its captain or tug master – an employee of the *Carroll Towing Co.* – and a harbourmaster – employed by the lessee of the "Joseph F. Carroll", *Grace Line Inc.* Various mooring lines ran between the two sets of ships' berths along both piers to secure the individual barges. In order to access the barge to be pulled out by the "Joseph F. Carroll", these ropes had to be released. To this end, the captain of the "Joseph F. Carroll" set down a deckhand and the harbourmaster at the ship's berth of Pier 52, where the "Anna C." was also berthed. The deckhand and the harbourmaster went on board the individual barges and slackened the rope securing them to the pier before releasing the anchor lines. Thereafter they returned on board the "Joseph F. Carroll". Not long afterwards, the ships from Pier 52 broke loose, since the line had obviously not been sufficiently re-tightened. Thereupon the "Anna C." collided with the propeller of a tanker, was

[38] For this reason it is also commonly referred to as the *Learned Hand formula* or *Learned Hand test* in the literature.

[39] Cooter and Ulen, p. 215; Mathis, *Efficiency*, p. 77.

[40] 159 F.2d 169 (2d Cir. 1947).

holed in the side, capsized, lost its cargo and finally sank into the ocean. At this time the barge attendant, who should have been on board the Anna C., had been elsewhere. Had he been on board, and had he fulfilled his duty of supervision, then he would have seen that the "Anna C." had been holed and could have prevented it from sinking and losing its cargo by summoning assistance from other ships in the immediate vicinity.[41]

On the facts of this case, Judge Hand had to decide who could be made liable for the harm that arose. The parties with a potential liability were the *Carroll Towing Co.* as the owner of the "Joseph F. Carroll" and employer of the tug master and deckhand, who had not re-tightened the rope properly. The *Grace Line Inc.* as lessee of the "Joseph F. Carroll" and employer of the harbourmaster was accused of the same misconduct. Finally, the *Conners Marine Co.* as owner of the "Anna C." and employer of the barge attendant were held accountable for his absence and non-performance.[42]

For want of a relevant behavioural norm, Judge Hand based his assessment of negligence on *cost-benefit considerations*, in order to determine the standard of care in the given case. Essentially he identified three variables which needed to be considered to determine the level of due care in the concrete case, and constructed an algebraic expression from them:

> Since there are occasions when every vessel will break from her moorings, and since, if she does, she becomes a menace to those about her; the owner's duty, as in other similar situations, to provide against resulting injuries is a function of three variables: (1) The probability that she will break away; (2) the gravity of the resulting injury, if she does; (3) the burden of adequate precautions. Possibly it serves to bring this notion into relief to state it in algebraic terms: if the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether $B < PL$.[43]

Using this formula Judge Hand came to the conclusion that the collision damages to the "Anna C." should be borne half each by *Grace Line Inc.* and the *Carroll Towing Co.* The sinking damages, i.e. the loss of the "Anna C." and its cargo, on the other hand, he split three ways between *Grace Line Inc.*, the *Carroll Towing Co.* and the *Conners Marine Co.*[44]

8.3.2 Formulation and Application of the Hand Rule

The formula contained in Judge Hand's ruling quoted above is known today as the Hand rule and is acknowledged in the Law and Economics literature as the first

[41] For a complete account of the case and discussion of the ruling see Feldman and Kim, pp. 525 et seqq.

[42] Feldman and Kim, p. 527.

[43] *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947).

[44] Feldman and Kim, pp. 527 et seq.

attempt to make use of cost-benefit analysis to define the standard of care when determining negligence in tort law.[45] According to this rule the standard of due care in a concrete case is measured as follows: the party to which the formula is applied acts negligently if

$$B < P * L.$$

This algebraic formula is composed of three variables, where B represents the *burden* of costs of the necessary precautions, P stands for the *probability* of the accident, and L for the magnitude of the expected *loss*. Working the algebraic expression through, behaviour is always negligent if the expected costs of an accident (P * L) are greater than the costs of preventing it (B). If, on the other hand, the costs of avoiding an accident would amount to more than the expected value of the potential harm, then no liability arises for omitting to take the appropriate precautions. In other words, a particular action is only required if it is efficient, i.e. if it generates more benefits than costs for society.[46]

In its original form, however, the Hand rule is only suitable for answering the question of *whether* due care has or has not been taken in a concrete case, since it only compares the total costs to the injurer and to the victim of an incident of harm.[47] When it comes to ascertaining *how much* additional expenditure should be devoted to precautions in order to achieve the necessary – i.e. optimum – standard of care, then the marginal costs must be compared with the marginal damages, for which the Hand rule must be expressed in its marginal form.[48].

As the following graph (Fig. 8.1) shows, the optimum standard of care (c*) for the potential injurer is at point $B = P * L$, i.e. where the costs of precautions exactly match the expected damages.[49] Accordingly, to the left of c* the potential injurer acts negligently and consequently exposes himself to liability, whereas to the right of c* he has taken sufficient precautions and cannot therefore be held responsible in tort law.[50] In order to avoid liability due to negligence, he must invest in precautions for as long as each unit of additional expenditure on precautions reduces the expected damages by an equal or greater amount than that additional cost.[51]

[45] Feldman and Kim, p. 523.

[46] Mathis, 'Consequentialism', p. 21.

[47] Mathis, *Efficiency*, p. 77.

[48] Perry, p. 71; Posner, *Economic Analysis of Law*, p. 214. On the social optimum of precautions, see Sect. 8.2.2 above.

[49] Mathis, *Efficiency*, p. 76.

[50] Posner, *Economic Analysis of Law*, p. 215. Note that the potential injurer cannot be made liable for additional precautions exceeding the optimum degree of care (= area to the right of c*), but for his part causes costs which are undesirable from a welfare-economic point of view.

[51] Cooter and Ulen, pp. 214 et seq.; Guttel, p. 1391.

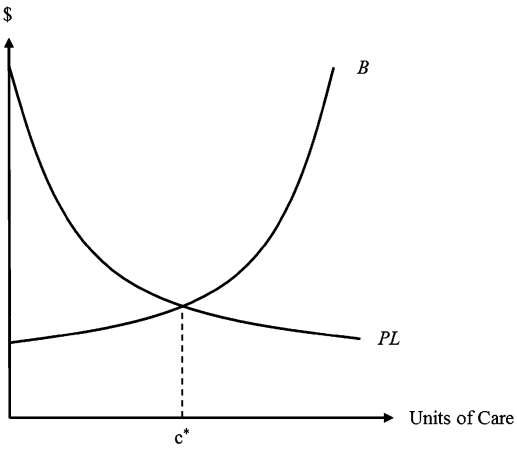

Fig. 8.1 Hand rule (Posner, *Economic Analysis of Law*, p. 215)

This sounds plausible enough in theory, but how is the Hand rule applied in a concrete case? The following example illustrates that in practice it can be used not only to assess the injurer's negligence but equally to determine any *contributory fault* of the victim.

A person jumps into a swimming pool and injures his head because the water is not deep enough. Now this person (the victim) demands damages from the owner of the swimming pool (the injurer) for having failed to place warning signs to alert people that the pool was not deep enough. In determining the due care of the owner, the following question is posed: are the costs of precautions (placing a warning sign) lower than those of a possible head injury? If so, the owner of the swimming pool has behaved negligently, although this fact does not necessarily make her solely responsible. It is further necessary to examine whether the victim, for his part, could have avoided an injury by complying with the principle of due care, e.g. by testing the water depth before diving in. If the costs of precautions on the victim's part (prior inspection of the water depth) are lower than those of a possible injury, then the victim also acted negligently and is jointly at fault. In this case the damages are usually split or the level of compensation reduced,[52] in a similar fashion to the historical judgement passed by Judge Hand in the case of *United States v. Carroll Towing Co.*[53]

[52] Since in this examples both parties fail to exercise due care, the decisive issue is which form of negligence liability is implied by the concrete case. In a case of *comparative negligence*, the costs of harm are split proportionally according to their respective degrees of negligence. In an instance of *simple negligence* or *negligence with a defense of contributory negligence*, however, in the first case the injurer and in the second case the victim bears the full costs of the harm. On this, see Cooter and Ulen, pp. 208 et seqq., as well as the paragraph on "Negligence Liability" in Sect. 8.2.3 above.

[53] See Sect. 8.3.1. above.

8.4 Critical Appraisal of the Hand Rule

At first glance, the Hand rule appears to be an extremely practical rule for determining negligence, since the court can define the standard of care individually for each tort case. This allows special attention to be paid to the particular circumstances of each case.[54] The process of consulting and weighing up costs and benefits makes judicial decision-making *more rational* and more comprehensible for the affected parties as well as the interested public, which improves the *transparency* of judicial practice. This in turn helps the potential injurer to gauge the risk of liability for negligence before an accident ever happens, so that he can choose to desist from a dangerous activity or, instead, take cost-effective precautions.[55] Despite these many advantages, certain problems arise with the concrete application of the Hand rule; for example, information and administrative costs, the issue of bounded rationality, variable activity levels, and the justice critique.

8.4.1 Information and Administrative Costs

A cost-benefit analysis – as represented by the Hand rule – presupposes that the decision-maker possesses the necessary information to make the calculation. Since this is rarely the case in practice, however, often *obtaining the missing information* requires a considerable amount of effort and hence additional costs – known as *information costs*.[56] When the Hand rule is applied, uncertainties and information deficits can occur in relation to all the variables in the formula. Thus, before a harmful incident, the potential injurer normally lacks reliable information regarding the probability (P) and likely magnitude of harm (L), knowledge of which is essential in order to quantify the cost or burden of precautions (B) in order to avoid liability.[57] If he is averse to the risk of liability and wishes to take appropriate precautions, he must incur additional costs to obtain the necessary information. Correctly, these information costs must be included in the calculation of the harm-avoidance costs.[58]

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[54] Cooter and Ulen, p. 215; Mathis, *Efficiency*, p. 77.

[55] Mathis, *Efficiency*, p. 77. Through this preventive effect the Hand rule contributes to minimizing the social costs of accidents, entirely in accordance with the aim of economic analysis of tort law. On this, see Sects. 8.2.1 and 8.2.2 above.

[56] Cooter and Ulen, pp. 217 et seq.; Hanson, Hanson and Hart, pp. 311 et seq.

[57] In bilateral accidents, the same applies to determining any contributory fault on the part of the injured party. On this, see Sect. 8.3.2 above. Ultimately, this results in *over-* or *underinvestment* in precautions, which impairs the welfare-maximizing function of the Hand rule. Grossmann, Cearley and Cole, pp. 4 et seqq.

[58] Schäfer and Ott, p. 192. Beyond this, it often remains unclear whether a precaution will produce the expected effect at all – for example, equipping a ship with lifeboats and lifejackets may not

Both *before* as well as *after* a harmful incident, critical information is often buried in obscurity, which is why the courts see themselves forced to procure the necessary information – in the form of reports by experts, empirical studies, etc. – and to incur additional costs.[59] Ultimately, this results in an increase in the *administrative costs* generally incurred during a court case. Taking the administrative costs into account, strict liability may be more efficient than negligence liability, even for bilateral accidents, since the court has only to determine whether or not the corresponding norm is applicable in the concrete case. Conversely, strict liability could lead to more legal disputes because if there is no proof of any careless behaviour, victims have a better prospect of damages, which in turn generates higher administrative costs.[60] In summary it can be said that strict liability tends to produce more but simpler cases to be ruled on, whereas negligence liability leads to fewer but more complicated and, accordingly, more costly court cases.[61]

One option for minimizing information and administrative costs is the *insurance market*, in that it provides a reliable information base – e.g. on the basis of accident statistics – for determining the probability and likely magnitude of harm from accidents.[62] However, recourse to data from the insurance market is limited to certain areas of risk – such as accidents in the home or in road traffic – which means that the information available for use in applying the Hand rule is incomplete.[63] Furthermore, it is conceivable that some damages cannot be quantified, or at least not in advance. This problem of commercialization or quantification is evident when it comes to the monetary valuation of human lives[64] or of certain collective goods, like the environment,[65] which has proved extremely difficult so far by traditional economic methods.[66]

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ensure that no passenger ever drowns. So uncertainty may exist not only about the *efficiency* of a precaution but also regarding its *effectiveness*. Medicus, p. 812.

[59]The parties try to alleviate this information problem by submitting their own information about precautions and accident-prevention impact to the court and by scrutinizing the opposing side's information, since they have an incentive to win the court case. Adams, p. 121.

[60]On this controversy see, for instance, Cooter and Ulen, pp. 223 et seq.; Posner, *Economic Analysis of Law*, p. 229; Schäfer and Müller-Langer, p. 24.

[61]Cooter and Ulen, pp. 223 et seq. However, according to Hanson, Hanson and Hart, p. 314, there is no empirical evidence about this.

[62]Grossmann, Cearley and Cole, pp. 9 et seq.

[63]On the limitations of the insurance market as an information basis, see Grossmann, Cearley and Cole, pp. 11 et seqq.

[64]On the valuation of human life, see Balz Hammer, 'Valuing the Invaluable'.

[65]In cases of harm to the environment, e.g. as caused by the nuclear reactor accident in Fukushima (2011) or the oil-drilling disaster in the Gulf of Mexico (2010), it is virtually impossible to ascertain the true magnitude of the harm because the ecological impacts of these incidents cannot yet be predicted.

[66]Medicus, p. 812.

8.4.2 Bounded Rationality

As has been shown, the potential injurer often lacks reliable information concerning not just the magnitude of harm but also the probability that the harm will occur.[67] Added to this uncertain basis of information is the fact that – contrary to the assumptions of the classical economic paradigm – people do not always behave rationally in relation to high-risk activities. Going back to Herbert A. Simon, the concept of *bounded rationality* expresses that people act rationally when making straightforward decisions whereas the rationality of their behaviour becomes more constrained in difficult situations.[68] Correctly assessing the extent and magnitude of probabilities often poses major difficulties for the individuals concerned, giving rise to *psychological distortions* in the perception and assessment of risks.[69] Due to the poor quality and inadequate quantity of the information basis, risks which are actually small are often overestimated while sizeable risks are underestimated.[70]

In the application of the Hand rule, this problem of over- or underestimation of risk is noticeable, on the part of both the court and the potential injurer. Because a judge is only called upon to assess a tort case after the harm has already occurred – i.e. when the risk has become a reality – the probability of the incident is often estimated to be greater than it really was prior to the incident. Here the court falls prey to what is known as *hindsight bias.*[71] As a consequence, given that the probability of occurrence is overestimated *ex post*, the expected costs of harm (P * L) are calculated to be considerably higher than would have been the case *ex ante*. The court now finds that the injurer ought to have spent more on precautions, to meet the standard of due care and avoid liability, than he might have assumed before the incident occurred.

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[67] See Sect. 8.4.1 above. Posner, *Economic Analysis of Law*, pp. 216 et seq., refers in this connection to the important distinction between calculable risk and uncertainty. As he points out, the Hand rule assumes that risk is calculable, i.e. the probability is a number between 0 and 1. Yet in some cases this number cannot be quantified precisely, and the probabilityof the occurrence of harm is uncertain.

[68] See the thorough discussion in Herbert A. Simon, 'A Behavioral Model of Rational Choice'.

[69] On the theme of psychological distortions, particularly in judicial judgements, see Klaus Mathis and Fabian Diriwächter, 'Is the Rationality of Judicial Judgements Jeopardized by Cognitive Biases and Empathy?'.

[70] Hammer, p. 220. This critique on the misjudgement of risk is not to be confused with another critique directed against the basic economic assumption of the individual's risk-neutrality. Individual behaviour – the objection goes – is not, in fact, risk-neutral but fundamentally risk-averse, i.e. given a choice between several alternative courses of action with the same expected value, individuals always choose the one that entails the least possible loss; Hanson, Hanson and Hart, pp. 314 et seq. This argument from behavioural economics can be countered, however, with the point that potential injurers and victims are generally insured – so that the loss is spread across the total population of policyholders – which is why they behave risk-neutrally. Schäfer and Müller-Langer, pp. 33 et seqq.

[71] Mathis and Diriwächter, pp. 58 et seqq.

Conversely, if the potential injurer applies the Hand rule test to his own behaviour, the mistaken estimate of the actual probability of harm likewise leads to a *false assessment of the expected damages*. As a result, it is virtually impossible for him to determine with precision what amount of precautions are necessary in order to prevent this harm and thus exclude liability.[72] Ultimately this could lead to over- or underinvestment in precautionary measures, which relativizes the efficiency of the Hand rule and therefore conflicts with the goal of economic analysis of tort law, which is to minimize the social costs of accidents.

8.4.3 Activity Level

Essentially there are two ways in which the potential injurer can minimize the social costs of accidents: the first is to invest in precautions, and the second is to reduce the activity level, i.e. scale down *the frequency and duration of the risky behaviour*.[73] Since the Hand rule only sets the expected damages (P * L) against the burden of precautions (B), however, it is susceptible to the objection that it assumes the activity level of the parties to be constant.[74] There are certain constellations of harms – such as accidents in the home – where this premise may well be accurate. In other situations, however, the potential injurer not only controls the extent of precautions but can also exercise an influence over the riskiness of the activity. For instance, people themselves are in control of *how often and for how long* they drive a car.[75] Someone who engages in the activity less frequently generally lowers the probability of an accident, and hence the total of harms for society as a whole.[76] It follows that raising or lowering the activity level results in a proportional increase or decrease in the expected damages. The Hand rule, however, cannot adequately take account of such changes in activity level; hence it can lead to inefficient behaviour by parties in constellations where the activity level is variable.[77]

These considerations also show that the problem of considering the activity level is not just conceptual but poses an equal *problem for legal practice*. While courts are fundamentally in a position to examine the due care or precautions taken, they normally find it difficult to observe whether the optimum activity level has been

[72] Cooter and Ulen, pp. 231 et seq. Moreover, there can also be a degree of uncertainty regarding the effectiveness of precautions; see Sect. 8.4.1 above.

[73] Hartmann, p. 67; Polinsky, pp. 50 et seq.

[74] Hanson, Hanson and Hart, p. 302.

[75] Brown, 'Liability Rules', p. 40; Schäfer and Ott, p. 131.

[76] Hartmann, p. 67. A counter-argument, however, is that for certain dangerous activities, experience and practice in turn reduce the probability of accidents or harm. It is well known that people who seldom operate a chainsaw are more injury prone when they do so.

[77] Cooter and Ulen, p. 212; Schäfer and Müller-Langer, pp. 8 et seq.

exceeded.[78] Thus, a court has little means of knowing whether an otherwise careful car driver has been driving excessive distances; only the driver himself is aware of that fact. In the end, this *information asymmetry* between the potential injurer and the court gives rise to practical consequences for the formulation of tort law, which set limits on the applicability of the Hand rule: where the activity level is constant, the Hand rule can be applied; for a variable activity level, on the other hand, strict liability can be more efficient.[79] Therefore instances of harm that occur under the condition of a constant activity level must be differentiated from those which arise when the activity level is variable. On the grounds of law and economics, when attributing liability in cases of the latter type, the legal system would have to take account not only of the optimum degree of precautions, but also – as far as possible – the optimum level of activity.[80] It would be ideal indeed if a liability rule set the right incentives for maintaining the optimum *level of activity and due care* both for the potential injurer and for potential victims, but unfortunately no such rule exists as yet.[81] In any case, whether the activity level can be a reference point for liability must be questionable in legal policy terms.

8.4.4 The Justice Critique

Apart from the objections discussed above which are levelled mainly at the practicability and impact of the Hand rule, jurists and philosophers also express fundamental criticism of this economic model. In endeavouring to determine due care with reference to cost-benefit considerations, they claim, it is oriented to the efficiency paradigm alone and entirely disregards the question of justice. This is felt to contradict the traditional juristic approach to tort law, whereby its primary purpose is to regulate the compensation of harm between parties by granting the victim a right to be compensated by the injurer for the harm suffered.[82] This victim's

[78] Hanson, Hanson and Hart, p. 313. In welfare economic terms, the optimum activity level is precisely where the social utility generated by an increase in the activity level equals the additional expected costs of damages. Schäfer and Ott, p. 132.

[79] That is probably why most national legal systems have chosen to formulate driver's liability not as negligence liability but as strict liability, even though it is a prime example of a bilateral accident, since essentially both road-users can take precautions. For the Swiss regulation see Art. 58 Swiss Road Traffic Act (SVG, SR 741.01).

[80] Cooter and Ulen, p. 212; Polinsky, pp. 51 et seq.; Schäfer and Ott, pp. 131 et seq.

[81] Brown, 'Liability Rules', p. 40. Steven Shavell was the first to arrive at this fundamental insight in his essay 'Strict Liability versus Negligence'.

[82] This critique is not directed against the Hand rule alone, but against the economic analysis of tort law in general. On this, see Sect. 8.5.1 above.

right to compensation, they assert, is not a question of efficiency but of justice; of *corrective justice* to be precise.[83]

Ernest J. Weinrib sees corrective justice as the central ordering principle of tort law.[84] This principle contains the inherent structural idea that liability undoes the wrong that one person has done to another. Wrong arises, according to Weinrib, when one party gains an advantage and the other suffers a correlating loss. Tort law has to correct this wrong by compensating the loss of the one with the benefit of the other and thus restoring the original parity of the two parties.[85] For Weinrib, the *correlativity* between wrong and loss demands that courts, in striking a balance between injurer and victim, take into account their interests alone and do not go beyond that to pursue society-wide goals of any kind.[86]

The critique by Jules L. Coleman is aimed in a similar direction. He objects to a purely economic view of tort law because it is incapable of expressing the *normative relationship* between the injurer and the victim (so-called bilateralism critique).[87] This approach takes no notice of the fact that the harmful event gives rise to a new legal relationship between the parties, which obliges the injurer – if all the criteria for liability are met – to compensate the victim for the harm suffered. To give appropriate acknowledgement to this normative relationship between injurer and victim, Coleman advocates the principle of corrective justice which, in his view, represents the centrepiece of tort law. This principle decrees that those individuals who are responsible for unlawfully harming others are bound by an obligation to make good the harm done.[88] The task of an adequate liability rule, according to Coleman, is now to clarify this normative relationship and to restore the balance between the given parties. This aspiration, he contends, will not be fulfilled by the Hand rule.[89]

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[83] As per Coleman, pp. 13 et seqq.; Weinrib, pp. 355 et seq. According to George P. Fletcher, 'Fairness', p. 540, this dispute goes back to the fundamental question of whether courts, in ruling on a tort case, can find their attention solely to the interests of the parties concerned or, instead, should resolve private disputes in such a way as to serve the interests of the community as a whole.

[84] Weinrib, p. 354.

[85] Weinrib, p. 349.

[86] Weinrib, pp. 355 et seq. Discussing the question of whether the court's decision-finding process has to give regard to the micro- and macro-level real consequences of its judgement, Mathis, 'Consequentialism', pp. 21 et seqq., points out the so-called *paradox of consequences* that can arise when the Hand rule is applied.

[87] Coleman, pp. 13 et seqq.; Mathis, *Efficiency*, p. 78; Mathis, 'Consequentialism', p. 23.

[88] Coleman, p. 15.

[89] Coleman, pp. 14 et seq.

8.5 Possible Applications of the Hand Rule in Swiss Tort Law

Having discussed and critically appraised the Hand rule as a standard of care for determining negligence in tort cases, the question now is to what extent this economic model can be turned to fruitful purpose for the Swiss tort law. The latter can be sub-categorized according to the classical distinction between *fault-based liability* and *causal liability*, where fault-based liability represents the principle and causal liability the exception. Under fault-based liability a person can only be made liable if they have inflicted harm culpably – i.e. with intent or negligence. Under causal liability, on the other hand, liability is attributed independently of any fault.[90] The latter category of liability can, in turn, be subdivided into simple and strict causal liability ("*milde Kausalhaftung*" and "*scharfe Kausalhaftung*"). Whereas it is possible to be discharged from simple causal liability[91] by providing evidence of due care, in the case of strict causal liability.[92]– also called risk liability ("*Gefährdungshaftung*") – the liability pertains in all cases and regardless of any considerations of care.[93] Accordingly, a standard of care – as the Hand rule provides – is only required for the assessment of liability in cases of fault-based liability and simple causal liability.[94] Therefore the following section will refer to fault-based liability and selected cases of simple causal liability in order to analyze the extent to which economic arguments – such as cost-benefit considerations – are already in use for determining due care in Swiss tort law today, and whether the Hand rule can therefore be applied as a standard of care in Switzerland, too.[95]

[90] Fellmann and Kottmann, § 1 N 15 et seqq.; Honsell, § 1 N 13; Oftinger and Stark, *AT*, § 1 N 102; Rey, N 66; Roberto, 'Unterscheidung', p. 1323.

[91] Examples of simple causal liability are animal keepers' liability (Art. 56 Swiss Code of Obligations [OR, SR 220]) or premises owners' liability (Art. 58 OR).

[92] Examples of strict causal liability are car-drivers' liability (Art. 58 Swiss Road Traffic Act) and the liability of nuclear power station operators (Art. 3 Swiss Nuclear Energy Liability Act [KHG, SR 732.44]).

[93] Honsell, § 1 N 17 et seqq.; Roberto, *Haftpflichtrecht*, N 34. Since the injurer is normally liable for the full harm under strict causal liability, irrespective of any considerations of care, this category of liability corresponds to the strict liability category in Economic Analysis of Law. On this, see the paragraph on "Strict Liability" in Sect. 8.2.3 above.

[94] Since the prevailing opinion conflates the lack of care with fault, the proof of care in simple causal liability actually means nothing other than *fault-based liability with a reversed burden of proof*. Roberto, *Haftpflichtrecht*, N 35; Honsell, § 1 N 23. Therefore in place of the traditional categorization of tort law, some advocate making a distinction merely between *liability for own misconduct* (fault-based and simple causal liabilities) and *liability for risks* (strict causal liability). For instance, Roberto, *Haftpflichtrecht*, N 36.

[95] Further examples of the use of the Hand rule in Swiss tort law in Sarah Kuhn, *Der effizienzorientierte Fahrlässigkeitsbegriff in der Rechtsprechung westlicher Staaten*, pp. 99 et seqq.

8.5.1 Fault-Based Liability (Art. 41 Swiss Code of Obligations)

Fault-based liability is framed as a blanket clause in Swiss law and regulated in the Swiss Code of Obligations (Art. 41 para. 1).[96] Accordingly, the individual is held responsible for any harm done to another person if it is caused unlawfully through intent or negligence. Intention and negligence are subsumed within the concept of fault in Swiss judicial practice and legal doctrine.[97] According to the traditional view, fault is understood to mean that a person of sound mind has not acted with the degree of care that the *average reasonable person would have taken in the same circumstances*.[98] However, this definition neglects to specify exactly how an average reasonable person should behave in these particular circumstances.[99] For a court to be able to deal with the question of fault in a concrete case, clarity on this matter is needed. Consequently the court requires a *standard of care by which to define reasonable,* i.e. *rational behaviour*.

As has already been shown,[100] the Hand rule presents such a standard of care and is used in US law to establish liability due to negligence, the pendant to Swiss fault-based liability. Because of the similarity of these two legal institutions, here and there the Swiss literature points out that in Switzerland, too, the level of due care when assessing negligent behaviour should be determined by comparing the *costs of preventing harm with the costs of harm*. Additional precautions to prevent harm are therefore to be ceased when the marginal extra effort is not offset by the costs of the harms thereby avoided.[101] With this in mind, Ernst A. Kramer for example argues emphatically in favour of *considering economic factors when concretizing* the key liability-law concept of *negligence*, and refers explicitly to the Hand rule. Although he concedes that it is equally in need of interpretation, he nevertheless finds it distinctly more comprehensible than the traditional description of negligence.[102] According to the view of Swiss Federal Supreme Court Judge Hansjörg Seiler and of Laurent Bieri, *application of the Hand rule* in Swiss tort law would already be possible now *de lege lata.*[103] The Hand rule could accordingly be consulted as a standard in order to determine the behaviour of a reasonable average person in the same situation.

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[96] Honsell, § 1 N 9; Rey, N 62; Oftinger and Stark, *AT*, § 1 N 103.

[97] Fellmann and Kottmann, N 525; Rey, N 834 et seqq.; Roberto, *Haftpflichtrecht*, N 219; Oftinger and Stark, *AT*, § 5 N 14. In contrast, in US tort law, intentional harm is treated separately from unintentional, i.e. negligent harm. Cooter and Ulen, p. 188; Perry, pp. 65 et seq.

[98] Bieri, p. 289; Honsell, § 6 N 4; Oftinger and Stark, *AT*, § 5 N 40; see also section "Negligence Liability" in Sect. 8.2.3 above.

[99] Bieri, p. 289.

[100] On this, see Sect. 8.3 above.

[101] Bärtschi, p. 134.

[102] Kramer, p. 256.

[103] Bieri, p. 296; Seiler, p. 150.

In consistent rulings on fault-based liability, the Swiss Federal Supreme Court has held that a lack of due care is always present if the injurer's actual behaviour differs from the *hypothetical behaviour of a reasonable average person in the same situation.*[104] This paraphrase was also invoked by the Federal Supreme Court in BGE 137 III 539, for instance, in a ruling on the parental duty to supervise children. While the parents were away, the neighbour was looking after their 4 year old daughter, who together with their 5 year old son and another 5 year old boy were playing in the garden while she carried out the housework. During this time the 4 year old girl fell into the nearby river and was only rescued after 10 min. As a result she suffered anoxic brain injury rendering her an invalid requiring constant care and supervision. In concretizing the level of due care, the Federal Supreme Court deemed it "out of touch with real life" to assume that parents would monitor their children at regular 5–10-min intervals, provided that they stayed close by and were occupied with non-hazardous games. Instead, it was far more likely that the parent in charge of supervision would be occupied at times with household tasks and could not devote constant attention to the children. Household tasks can only be interrupted at irregular intervals, for which reason continuous monitoring and control of children in these circumstances is not indicated.[105]

Although the Court does not refer explicitly to costs and benefits in this ruling, on closer examination some aspects of its deliberations are recognizably economic in nature, because in determining due care it sets the *intensity of supervision in relation to the domestic tasks to be accomplished, on the one hand, and the hazardousness of the children's activities, on the other*. Since permanent or at least stricter supervision would have been required to prevent the harmful event, this in turn would have resulted in the interruption of household tasks for the entire duration of supervision. In economic terms, supervising the children has an opportunity cost – i.e. the sacrifice of some utility – because the immediate household tasks could not be done. Furthermore the Court makes the intensity of supervision dependent on the hazardousness of the children's activities. In doing so, it incorporates the probability of the incidence of harm into its calculus: the more dangerous the children's activity, the more intensive the parental supervision required. As a result, it implicitly weighs the costs of precautions against the probability of harm. Thus it becomes clear that the Swiss Federal Supreme Court, in concretizing the standard of due care for the parental duty of supervision, is taking recourse to certain variables of the Hand rule, at least in a rudimentary way.

This is seen in more concrete terms in the judicial practice of the German Federal Court of Justice. It had to rule on a case in which a motor vehicle driver had an accident on an out-of-town bridge at night, caused by an icy road surface.[106] The ice had formed in the cold temperatures because the road had not been gritted. The

[104] Cf. for instance BGE 137 III 539, E. 5.2; BGE 116 Ia 162, E. 2c; BGer 4A_22/2008 of April 10, 2008, E. 4.

[105] BGE 137 III 539, E. 5.2.

[106] BGHZ 40, 379.

vehicle driver therefore sued the local agricultural association, which is responsible for the maintenance of the road in question, for non-fulfilment of its traffic safety obligations. In Germany, too, one acts negligently and is held liable according to fault-based liability,[107] if one omits to exercise the requisite care in traffic (§ 276 para. 2 German Civil Code). The degree of care demanded is that which would be exercised by a *reasonable average person.*[108] The Federal Court of Justice held in its ruling that the obligation to grit the road, deriving from the general traffic safety obligation, was limited in scope to the "use of reasonable means". Thus, outside towns it was only necessary to grit particularly dangerous sites, and in the daytime only as a matter of principle, since the effort of instituting a night-time gritting service on permanent stand-by would be excessive in consideration of the low number of night-time road users.[109] Consequently the Federal Court of Justice concluded that the defendant agricultural association had not disregarded its traffic safety obligation and could not be held responsible for the harm to the vehicle driver.

The deliberations of the Federal Court of Justice make it clear that in determining the extent of the obligation to grit the road, it undertook a cost-benefit analysis. On the one hand, it based its argumentation on the costs of precautions by citing the *effort* required for a permanent nightly gritting service, which would have been necessary in order to prevent the accident or harm. On the other hand it took into consideration the *probability of the occurrence of harm* by confining the obligation to grit the road to especially dangerous sites, and taking low traffic density into the calculus. Finally, it made its decision dependent on the relationship of these two variables. From this judgement it is evident that the Hand rule is reflected more clearly in the judicial practice of the Federal Court of Justice for determining due care in fault-based liability cases in comparison to that of the Swiss Federal Supreme Court.

8.5.2 Animal Keepers' Liability (Art. 56 Swiss Code of Obligations)

Art. 56 of the Swiss Code of Obligations imposes on the keeper of an animal a non-fault-based liability for the harm caused wrongfully and with causal adequance by his animal. Underlying this is the equity consideration that the person who gains the benefit or economic interest in the keeping of animals creates a risk for his environment by doing so, and should therefore be held liable in the event of

[107] Germany differs from Switzerland in that fault-based liability is not formulated as a blanket provision but is regulated in §§ 823 and 826 of the Civil Code (BGB) in the form of three general offence definitions, of which § 823 para. 1 BGB is very close in content to Art. 41 para. 1 Swiss Code of Obligations.

[108] Kötz and Wagner, N 113.

[109] BGHZ 40, 379, pp. 382 et seqq.

harm.[110] Being classified as simple causal liability, the animal keeper may present discharging evidence, i.e. he can discharge himself from liability by proving that he took all due care required by the circumstances to control and supervise the animal, or that the harm would have occurred even if this care had been applied.[111] The extent of care required is guided primarily by the safety and accident prevention regulations in force.[112] In the absence of statutory or regulatory provisions, it is necessary to examine what care is required according to the *totality of the concrete circumstances*.[113] This is not to be assessed *ex post*, however, but *ex ante*, i.e. the test must determine what care was appropriate before the incidence of harm. Consequently, based on a balancing of interests, it is necessary to clarify what safety measures can reasonably be expected from the keeper.[114] The required safety measures must be *financially reasonable* for the keeper and, furthermore, in *rational proportion* to the protected interest of the environment.[115]

In its judicial practice on animal keepers' liability, the Swiss Federal Supreme Court takes recourse to economic considerations at times when it has to make an assessment on due care. In BGE 126 III 14 it had to rule on a case in which a married couple out walking with their two dogs crossed a cattle pasture. 25 cows along with their calves were in the pasture, the perimeter of which was fenced in with barbed wire and a single electrified wire. Disturbed by the walkers, the cows became restless and charged at the couple, who let their dogs off the leash in response. In the chaos that ensued, the cattle barged the couple and jostled them to the ground, injuring them. In the absence of relevant safety regulations, the Court based its assessment of due care on "general principles of caution", and ruled on the case according to what measures might reasonably and proportionately be demanded of the keeper.[116] In view of the *low risk* of such an accident, it ruled that the constant presence of a keeper could not be demanded since the corresponding costs would be disproportionate. Supervision of the herd by an experienced herdsman who checked the pastures twice a day would have sufficed. Excluding access to the pasture completely would also have been associated with *disproportionate costs*. The risk of a serious accident while crossing a cattle-pasture is so low that the court thought it unreasonable even to demand warning signs for cattle pastures.[117] As a result, the Federal Supreme Court held the defendant's evidence of care to be satisfactory because sufficient precautionary measures had been taken, and cleared the keeper of any liability.

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[110] Honsell, § 17 N 4; Oftinger and Stark, *BT*, § 21 N 30 et seqq.

[111] Honsell, § 17 N 1; Rey, N 1012; Oftinger and Stark, *BT*, § 21 N 82.

[112] BGE 131 III 115, E. 2.1; BGE 126 III 113, E. 2b.

[113] Rey, N 1014; Oftinger and Stark, *BT*, § 21 N 88.

[114] Brehm, N 53 on Art. 56, Swiss Code of Obligations; Lüchinger, p. 78; Metzger, p. 97.

[115] Oftinger and Stark, *BT*, § 21 N 94.

[116] BGE 126 III 14, E. 1 b.

[117] BGE 126 III 14, E. 1 c.

A different decision was handed down by the Swiss Federal Supreme Court in BGE 102 II 232. A hiker making his way into an inn was surprised by a dog chained up in a nearby barn, which attacked him. Making his escape, the terrified visitor fell over a wall and shattered the first lumbar vertebra, which necessitated a period of hospital treatment lasting several months and resulted in his long-term incapacity. In this case once again, as there were no relevant safety regulations the Court relied on the "general principles of caution". It argued that the warning sign on the barn, displaying the words "Beware of the dog" ought to have been more prominent. To install a larger notice, the owner would have incurred only *minor additional costs* and should therefore have done so. Hence the dog owner was held responsible.[118]

In both cases, the Swiss Federal Supreme Court relied on cost-benefit deliberations in determining what amounted to due care, and at least implicitly considered individual variables of the Hand rule. In referring to the costs of installing a warning notice, it meant nothing other than the costs of harm avoidance. In the first case, moreover, by referring to the risk of a serious accident, it took the probability of the incidence of harm into its calculations. Finally, it held that the incurred costs would be disproportionate, which means that it ultimately *balanced the costs of avoidance against the costs of the harm*. It remains questionable, however, why the animal keeper in the first ruling was not made liable, and why the owner in the second case was, when in both cases the costs of precautions amounted to affixing a warning notice. Obviously the Federal Supreme Court estimated the probability of being attacked by chained dog to be higher than that of being attacked by cows when crossing a pasture.

8.5.3 Premises Owners' Liability of (Art. 58 Swiss Code of Obligations)

Premises owners' liability pursuant to Art. 58 of the Swiss Code of Obligations is a simple causal liability,[119] whereby the owner of a building or premises of some other kind is liable for harm that is attributable to a defect in the premises. The term premises ("*Werk*") is understood to mean a building or other stable, artificially fabricated, structural or technical facility that is permanently sited on the ground.[120] The *premises defect* may consist of faulty installation or construction or poor maintenance of the premises, is found when the building does not offer

[118] BGE 102 II 232, E. 1 a.

[119] In contrast to the animal keepers' liability, proof of due care is not an option for premises owners, and some therefore argue that this is a strict form of causal liability. See for instance Honsell, §18 N 2. As a matter of fact, the premises owner is not liable *per se* for all harms that go back to a cause; in fact the premises must have been poorly built or maintained, which is why premises owners' liability can in fact be categorized as a form of simple causal liability. Honsell, § 3 N 35.

[120] Roberto, *Haftpflichtrecht*, N 394; BGE 130 III 736, E. 1.1; BGE 121 III 448, E. 2a.

sufficient safety when used in accordance with regulations.[121] The limits on this duty to ensure safety are formed by the personal responsibility of the user, and the principle of *reasonableness.*[122]

Legal doctrine increasingly requires reasonableness to be measured against what is technically possible without incurring excessive costs. Precautions, then, are only necessary up to the point that they are *economically proportionate*, i.e. efficient.[123] According to Roland Brehm, the reasonableness of accident prevention measures on the part of the premises owner should be assessed by means of a *comparison of costs and benefits.*[124] Vito Roberto even refers explicitly to the Hand rule and argues that a premises defect is found if the costs of safety measures are lower overall than the magnitude of the potential harm multiplied by the probability of that harm's occurrence.[125]

The Swiss Federal Supreme Court also follows this doctrine. In its consistent rulings on premises owners' liability, it points out that *the costs of precautions* are to be seen as the *limit on reasonableness*. In BGE 117 II 399 an 80-year-old woman tripped over a 12-cm-high step when leaving her hotel-room toilet, and received various injuries. The Federal Supreme Court comments in its deliberations that when assessing whether or not a premises defect exists, consideration should be given to whether the corresponding *costs are in reasonable proportion to the protected interests of users and the intended purpose of the premises*. According to the judicial practice of the Federal Supreme Court a stricter scale of assessment is justified when simple, low-cost precautions would be sufficient to prevent the danger effectively. This – according to the court – would have been the case if the edge of the step had been marked more prominently. The necessary costs of such a precaution would have been negligible but would have substantially reduced the probability of harm. Therefore in the present case it found a premises defect because of the insufficient visual marking of the step and the lack of a warning notice.[126]

Once again, cost-benefit considerations were referred to by the Swiss Federal Supreme Court, although it found no premises defect, in BGE 130 III 736. A three-and-a-half year-old girl had fallen into a dyke beside a road, and had been washed downstream and seriously injured. The plaintiffs brought an action for a premises defect, claiming that the road and the dyke had not been made safe enough. On this point, the court held that lower standards were to be expected for the installation and maintenance of roads. The *costs must always be in reasonable proportion to the protected interests of users*. The road network could not be maintained to the

[121] Roberto, *Haftpflichtrecht*, N 399 et seq.; BGE 130 III 736, E. 1.3.

[122] Roberto, *Haftpflichtrecht*, N 401; BGE 130 III 736, E. 1.3.

[123] Brehm, N 58 on Art. 58, Swiss Code of Obligations; Oftinger and Stark, *BT*, § 19 N 78 et seq.

[124] Brehm, N 60 on Art. 58, Swiss Code of Obligations.

[125] Roberto, *Haftpflichtrecht*, N 401.

[126] BGE 117 II 399, E. 3e.

same degree as an individual building.[127] Nobody could expect every road to offer the maximum possible degree of traffic safety because the sheer effort it would take would be excessive. For that reason, the complaint was dismissed.

The Swiss Federal Supreme Court went one step further in BGE 126 III 113. A father and daughter were riding up on a ski-lift when the daughter suddenly fell off the lift and slid down the slope on her back. At this, the father let go of his T-bar and went after his daughter on his skis, following the ski-lift route. By the time he reached his daughter's altitude he was concentrating on her alone, and in his distraction collided with one of the lift masts, which resulted in multiple injuries. Following this incident he brought a case against the ski-lift operator for damages because the base of the mast was not padded. In examining the claim for a premises defect, the Federal Supreme Court explicitly pointed out that to assess the reasonableness of safety measures, the aspects to be considered were *on the one hand the effectiveness of the measure and its costs and disadvantages, and on the other hand the probability of the incidence of harm and the magnitude of that harm.*[128] In the end, it found no premises defect and hence no liability on the part of the ski-lift operator.

To sum up, in the Swiss Federal Supreme Court's rulings on premises owners' liability, cost-benefit considerations recognizably play a central role in the assessment of liability, in that the Federal Supreme Court regularly demands that expenditure on harm prevention must be in reasonable proportion to the protected interests of users, and that precautions are only necessary to the extent that they are economically viable.[129] In the last case described, the Federal Supreme Court takes into its deliberations all the variables of the Hand rule in full – the burden of costs of preventing harm (B), the probability of occurrence (P) and the potential magnitude of the loss (L) – and sets them against each other, which is ultimately equivalent to the Hand rule.

8.6 Conclusion

In US law, the Hand rule is familiar as a *practical instrument for defining due care* in negligence liability. It states that a potential injurer acts carelessly, and hence negligently, if the costs he incurs to avoid harm are lower than the magnitude of the potential loss multiplied by the probability of the harm occurring. The purpose of

[127] BGE 130 III 736, E. 1.4.

[128] BGE 126 III 113, E. 2b.

[129] As for example in BGE 129 III 65, E. 1.1; BGE 126 III 113, E. 2b; BGE 121 III 358, E. 4a; BGE 117 II 399, E. 2; BGE 106 II 208, E. 1a; BGE 100 II 134, E. 4.

such a standard of care is to set the right incentives to bring about *efficient behaviour* by both the potential injurer and the victim, in the ultimate aim of maximizing social welfare. In addition to this welfare effect, the weighing of costs and benefits brings *rationality and transparency* to judicial decision-making. As a result, the addressees of the law are in a better position to assess what legal consequences will ensue from their risky behaviour.

Alongside these advantages, however, the concrete use of the Hand rule also poses a variety of problems. Such a cost-benefit analysis presupposes that the relevant decision-makers will be in possession of a *body of information* which in many cases can only be achieved with difficulty, if at all, and only by incurring additional costs. Moreover, this formula starts from the *unrealistic premises* that the respective actors always act rationally and that the level of their risky activity remains constant at all times. For that reason, its use in certain case constellations – such as car accidents – can result in inefficient outcomes. Finally, criticism is voiced from a legal-philosophical perspective that this model aligned to the efficiency paradigms pays too little heed to the *principle of corrective justice*, which traditionally underpins tort law. Therefore it must not be forgotten that, in addition to its preventive function, tort law is traditionally required to fulfil a compensatory function. An adequate liability rule is therefore expected not only to have a deterrent effect but also, and especially, to effectuate the compensation of losses fairly. After all, the courts must not decide tort cases on the basis of a cost-benefit balancing test alone, but must also restore the balance between the interests of the injurer and the victim. For this reason the question of liability will continue to be a value-judgement question, in which considerations of justice will play a substantial role alongside the efficiency principle.

A look at *Swiss tort law* has shown that economic considerations have already made their presence felt in the determination of due care, since reference has been made both in doctrine and legal rulings to the costs of avoidance, the magnitude of the potential loss and the probability of harm. Thus, the Swiss Federal Supreme Court makes use of cost-benefit considerations, for instance, to determine the *hypothetical behaviour of a reasonable average person* when ruling on fault-based liability, in order to determine the animal keeper's *duty of supervision* when ruling on liability for animals, and finally in order to concretize the *reasonableness* criterion in relation to premises defects when ruling on premises owners' liability. At the same time, this practice clearly shows that it is not just in fault-based liability cases but particularly also in cases involving simple causal liability, that economic arguments can be brought into play in order to define due care. Although the information required for their use is not always available in a complete and accurate form, the present study shows that cost-benefit considerations already play a decisive role in defining due care today. Therefore the *regulating idea* of the Hand rule permits a theoretical reconstruction of what has already begun to develop casuistically in the practice of the Swiss Federal Supreme Court.

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Chapter 9
Efficiency and Swiss Contract Law

Ariane Morin

Abstract When you look at contract law in the USA, it is almost impossible to escape the economic analysis of law, also called Law and Economics (LAE). It is probably the dominant academic style of US contract theory, even if it does not seem to have a strong influence in contractual practice.[1] LAE does not have the same weight in Europe, where its role in law school curriculum remains sparse,[2] nothwithstanding a possible trend to use economic analysis of law, evidenced by a growing number of references to LAE in scholarly writings, most notably about contract law.[3]

In this essay, I will try to determine to what extent LAE can really influence the development of civil contract law. My field of analysis is thus limited: the idea is neither to discuss LAE as it is in the USA, nor to look at civil contract law *de lege ferenda*, nor to examine generally the use of economic reasoning to decide a case in civil law. Rather the goal is to form an opinion about the validity of transposing some US legal-economic theories *de lege lata* in civil contract law, as some European scholars try to do. My point is that the main issue here is the confrontation between efficiency, the value at the core of these theories, and the values founding civil contract law. After a general presentation of the problem, the analysis of this confrontation will be made using Swiss contract law as a representative example.

[1] Di Matteo, Prentice, Morant and Barnhizer, pp. 48 et seq.; Grechenig and Gelter, p. 297; Hackney, pp. 164 et seqq.; Eric A. Posner, pp. 868 et seqq.; Smith, pp. 133 et seq.; Von Bogdandy, p. 3.

[2] Grechenig and Gelter, p. 295.

[3] One good example of the influence of LAE on civil contract law that is the assertion by the authors of the academical DCFR that *de lege ferenda*, efficiency should be one of the leading principles of european contract law, cf. Von Bar and Clive, p. 37.

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9.1 The Challenge of an Economic Analysis of Civil Contract Law

9.1.1 The Perspective of the Authors Using Law and Economics in Civil Contract Law

For LAE scholars influential in Europe, economic efficiency is the purpose of contract law. In short, efficiency is reached when there is an allocation of resources in which venal value is maximized.[4] Thus, contract law should lead to an allocation of risks connected to an exchange (for example the sale of a good) that is advantageous for both parties, because it has the least effect on the price.[5] This approach is based on the assumption that people make rational choices to maximize their satisfaction,[6] and therefore seek an efficient solution.[7] Contract law should then mainly be focused on two goals: on providing correct information to the parties so that they can make their rational choices, and on limiting their transactions costs.[8]

In this regard, economic analysis of law has two functions, both based on the assumption that efficiency is the essence of contract law[9]:

- The descriptive function is used *de lege lata*, to see if positive contract law leads to efficient solutions, and further, to explain why certain legal norms exist.
- The normative function is used *de lege ferenda*, to describe how contract law should be to maximize efficiency.

This conception of contract law is mostly influenced by what is called Chicago LAE (as promoted by Richard Posner), so that the impact of LAE in Europe does not give a correct view of the broader field of LAE in US legal thinking.[10] Most European legal scholars do not follow the more subtle developments of behavioural LAE, which refine the simplistic ideal of the rational *homo economicus* by taking account of the irrational behaviour of people in real life. Nevertheless, behavioural LAE does this only to find more accurate ways to reach the goal of efficiency,[11] therefore the difference with the so-called Chicago LAE is relative.

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[4]Faust, pp. 842 et seqq.; Polinsky, pp. 7 and 163 et seqq.; Richard A. Posner, pp. 10 et seqq.; Schäfer and Ott, p. 1.

[5]Cohen, p. 126; Crasswell, p. 508; Hatzis, pp. 162 et seqq.; Mackaay, p. 425; Posner and Rosenfield, pp. 88 et seq.; Smith, pp. 108 et seqq.

[6]Mackaay and Rousseau, N 98 et seqq.; Mathis, pp. 11 et seq.; Richard A. Posner, pp. 3 et seq.

[7]Crasswell, p. 508; Polinsky, p. 29; Richard A. Posner, p. 14; Posner and Rosenfield, pp. 88 et seq.

[8]Gillette, pp. 119 et seq.; Mackaay, pp. 425 et seqq.; Mackaay and Rousseau, N 1333 et seqq.; Posner and Rosenfield, pp. 88 et seq.; Von Bar and Clive, pp. 38 and 60 et seqq.

[9]Eric A. Posner, pp. 833 et seq.; Schäfer and Ott, pp. 278 et seq.

[10]Grechenig and Gelter, p. 300.

[11]Vandenberghe, pp. 401 et seq. and 412–414; Georgakopoulos, pp. 59–66; Kornet, p. 367; Mackaay and Rousseau, N 50.

Both functions of economic analysis of law can be used in a theoretical or in a doctrinal perspective.

The perspective is theoretical if efficiency is considered regardless of its actual influence on the legislator's will. In this case, the economic analysis of law is essentially political: the goal is not to understand how contract law really works, but how it could work in consideration of the postulate that economic efficiency should be the purpose of contract law. This approach requires more social science than legal thinking, at least in the doctrinal tradition commonly followed in Europe, and its impact on civil contract law would certainly be limited.[12]

Indeed, European scholars do not use LAE in a purely theoretical way. They assume that civil contract law is actually based on the ideal of efficiency, which should be understood as the leading principle of the law. From this point of view, LAE are used from a doctrinal perspective, to systematically expose the law and find out what it is.[13]

From this doctrinal perspective, the descriptive function of the economic analysis of law serves as a guide in the interpretation of the law, stating that the meaning of law that must prevail is the one that leads to an efficient solution. The normative function should help the creation of legal rules, which have an efficient impact. The goal of the doctrinal perspective is of course to influence legal practice by leading the judge in his application of the law. This perspective intends to look at the law from the inside and thus directly concerns European lawyers, which explains why economic analysis of law is debated among them.[14]

9.1.2 The Receptivity of Civil Contract Law to Law and Economics

The Relative Scope of Efficiency

One cannot understand properly the challenge of economic analysis of contract law without taking into account that in itself, there is nothing scientific in the idea that economic efficiency is the goal of contract law. It is a belief, a choice of value, based on moral, philosophical and political premises linked to the US socio-historical context, such as the influence of utilitarianism or the impact of legal realism on

[12] Ackermann, pp. 944 et seq.; Eidenmüller, pp. 8 et seq.; Faust, p. 849; Graziadei, p. 464; Eric A. Posner, pp. 864 et seqq.; about the doctrinal tradition followed in Europe, see Grechenig and Gelter, pp. 345 et seqq., 353 and 359 et seq.; Hatzis, pp. 169 et seqq.; Kramer, 'Rechtswissenschaft', pp. 51 et seqq.; Von Bogdandy, p. 3.

[13] Eidenmüller, pp. 8 et seq. and 404 et seqq.; Faust, pp. 842 et seqq. and 848; Fikentscher, pp. 14 et seqq.; Mackaay and Rousseau, N 22. For examples, see Bieri, 'Responsabilité', pp. 519 et seqq.; id. 'Possibilité', pp. 201 et seqq.; Hatzis, pp. 176 et seqq.; Schäfer and Ott, p. 11; Mackaay and Rousseau, N 1326 et seqq.

[14] Eidenmüller, pp. 7 et seqq.

US legal thinking.[15] As this context is different in Europe,[16] it is not possible, then, to assume without further analysis that efficiency has a universal scope and forms the *ratio legis* of positive civil contract law. Civil contract law may eventually tend to efficiency, as it regulates the exchange of goods and services. But it may not, because nothing prevents it from relying on other values, for example the need of a social statute, of security and dignity, or the realization of affective interests.[17]

This is not problematic in the field of civil law, where the law is normally drawn up by the parliament, and thus is always a result of choices of value. In other words, the arguments used as *ratio legis* in civil law must express some political goals, deriving from a particular socio-historical context, that the legislator wants to reach by enacting legal rules.[18]

But if the scope of efficiency is only relative, there can be no question that efficiency is the (implicit) *ratio legis* of civil contract law. Since it is a belief, not more universal than other choices of value civil contract law may be based on, it is necessary to check that it is really the final goal of civil contract law, before conducting any economic analysis of this law from a doctrinal perspective.

Economic Analysis of Law and Comparative Law

This process relates to comparative law, more precisely to the difficulty of transplanting an idea (efficiency as the final goal of law) developed in the particular context of US common law, to the different context of civil law.

The adoption of concepts developed in a foreign legal culture is a very common and ancient phenomenon in civil law countries. One needs only to think about the transplant of product liability from the US to the European law, or about the CISG, with its remedies strongly influenced by common law solutions.[19] In this regard, European lawyers who bring LAE back from their studies in the USA can be compared to the lawyers who, back from their studies in northern Italy Universities, spread the *ius commune* through Europe in the Middle Ages.[20]

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[15]Grechenig and Gelter, p. 335; Eidenmüller, pp. 169 et seqq.; Fezer, p. 823; Hausman and McPherson, pp. 675, 693 et seq. and 702 et seqq.; Mathis, pp. 49 and 143 et seqq.; Mattei, 'Rise and Fall', pp. 229–234 and 240 et seqq.; pp. 655 et seqq.; about the US context, see also Feldmann, pp. 91 et seqq.; Fletcher and Sheppard, pp. 454 et seqq.; Hackney, pp. 108 et seqq.

[16]Grechenig and Gelter, pp. 307 et seq. and 335 et seqq.

[17]Collins, *Contracts*, p. 30; id., 'Cosmopolitan', pp. 314 et seq.; Eidenmüller, p. 273; Hausman and McPherson, p. 676; Hesselink, p. 50; Mahlman, pp. 218 et seq.; Mak, 'Legal-Economic Reason', pp. 285 et seqq.; Mathis, p. 201; Von Bar and Clive, p. 37. See also Ackermann, pp. 934 et seq.

[18]Caroni, pp. 125 et seqq.; Mak, 'Europe-Building', p. 329; Pichonnaz, pp. 127 et seq. and p. 179.

[19]Mattei, *Law and Economics*, p. 24.

[20]Wiegand, pp. 230 et seq.

Nevertheless, the adoption of LAE in civil contract law can be successful if the context and the values specific to this law are taken into account,[21] in order to escape the risk of a simple colonization of European legal thinking by "US-like" legal thinking – which would certainly lead to a rejection of economic analysis by civil lawyers.[22] That efficiency is at the core of LAE as it has been developed by US scholars is not enough to infer that it is also at the core of positive civil contract law. As efficiency is only a belief with a relative scope, it is also necessary from a comparative perspective to check if the basic values of civil law coincide with this concept before doing any economic analysis of civil contract law – at least from a doctrinal perspective.[23]

9.2 Swiss Law as a Field of Investigation

Swiss private law presents some characteristics that make it especially interesting for analysing the role which efficiency can play in positive contract law.

9.2.1 Swiss Civil Code and Legal Transplants

The permeability to foreign influences is especially strong in Swiss contractlaw. Historically, the Swiss Civil Code (with its fifth book devoted to the law of obligations) is the result of the transplant from French, Austrian and German legal culture, which prevailed in Swiss cantons before the unification of Swiss private law. At that time, some cantons had codifications inspired by the French Civil Code, some by the Austrian Civil Code, Zurich had a Civil Code based on works of German legal scholars and some alpine cantons even had unwritten systems, based on old customary law. Swiss Contract law was devised at the same time as the German Civil Code, with reciprocal influences, by legal scholars who had studied in Germany. This strong German influence was increased by the presence of German law professors in Swiss universities, like Jehring and Windscheid in Basel, or later Von Tuhr in Basel and Zurich. Today, there are still numerous German professors in Swiss universities, and the Swiss Federal Court often quotes German decisions

[21] Berkowitz, Pistor and Richard, pp. 177 et seqq.; Peyer, pp. 110 et seq.

[22] Fezer, pp. 821 et seqq.; Mattei, 'Rise and Fall', pp. 236 et seqq.; Smith, p. 134; Stürner, pp. 17 and 22 et seq. In this regard, it is interesting to note that the resurgence of nationalism in European legal thinking could notably be explained as a reaction against the development of an European private law too much focused on wealth maximization, cf. Collins, 'Cosmopolitan', pp. 319 et seqq.; Mak, 'Europe-Building', pp. 335 et seq.

[23] Berkowitz, Pistor and Richard, pp. 177 et seqq.; Graziadei, pp. 459 and 464 et seq.; Fikentscher, pp. 16 et seq. and 117; Mattei, 'Rise and Fall', p. 234; Michaels, pp. 786 et seqq. and 791 et seqq.; von Bogdandy, pp. 3 et seq.

and literature in its judgments.[24] That great openness to legal transplants means that in Switzerland you will not find a resistance on principle to the adoption of foreign legal theories, such as LAE, based on the idea of a particular national legal culture.

Swiss Civil Code also played a role in the development of others civil law systems. With the French Civil Code of 1804 and the German BGB of 1896, the Swiss Civil Code of 1907 is one of the great European codifications, which influenced civil law codifications in the twentieth century. The most spectacular example of the influence of Swiss Civil Code is its complete reception in Turkey in 1926. The Swiss Civil Code also influenced almost all the modern civil codifications, notably the Mexican Civil Code in 1928, the Italian Civil Code of 1942 and the Greek Civil Code of 1946. One can even see some influence of the Swiss Civil Code in the Unidroit Principles or in the PECL or the more recent DCFR.[25] Finally, Swiss contract law is often chosen in international contracts, which may be one of the reasons explaining why Switzerland plays a leading role in international arbitration.[26]

For all these reasons, it is interesting to look at Swiss contract law (as included in the Swiss Civil Code) when analysing the role LAE should play (or not) in civil law, as it appears to be quite representative and influential, because of its openness to legal transplants and its role as a legal transplant.

9.2.2 The Flexibility Led to the Swiss Judge

From a doctrinal perspective, LAE should lead the judge in the application of the law.[27] In this regard, it is especially tempting to look at Swiss private law because of the flexibility granted here to the judge.

The Interpretation of the Swiss Civil Code

According to the constitutional principle of legality (Art. 5 BV), a Swiss judge must apply Swiss Civil Code in any private law litigation (Art. 1 ZGB).[28] This requires

[24] Berkowitz, Pistor and Richard, pp. 174 et seq. and 191; Kramer, 'Einfluss', pp. 371 et seqq.; Kunz, pp. 43 et seq.; Pichonnaz, pp. 126 et seqq.; Schwenzer, pp. 60 and 79 et seqq.; Walter, pp. 92 et seqq.

[25] Berkowitz, Pistor and Richard, p. 199; Kunz, pp. 53 et seq.; Morin, p. 219; Zweigert and Kötz, pp. 169 and 175 et seq.

[26] Pichonnaz, p. 216.

[27] *Supra*, 9.1.1

[28] BGE 131 II 562; Steinauer, N 27 et seqq.

the interpretation of the rules written in the Civil Code, not only to take into account the text, but also the history, the purpose and the systematic placing (Art. 1 para. 1 ZGB). The judge must combine all these elements of legal interpretation in a pragmatic and dynamic way to find the true meaning of legal rules in the normative system in accordance with the *ratio legis*.[29]

This mode of interpretation not solely focused on the text of the law can be explained by the open texture of the Swiss Civil Code.[30]

Indeed, the Swiss Civil Code is based on the idea that a code has to be popular and democratic, so that even people without formal legal training should be able to understand its content (even if though a specialist will always have a greater understanding of it).[31] The ideal of a popular code led to a text formulated as practical as possible, with provisions precise enough to settle an individual case, but also simple enough to express a general and abstract rule.[32] To reach this goal, the legislator assumed that it wasn't possible to describe in details all the situations covered by the code.[33]

Consequently, the provisions of the Swiss Civil Code are deliberately written in an incomplete manner. Unlike the German Civil Code, the Swiss Civil Code does not have a general part describing the basic concepts of private law (for example the notion of legal acts, or the concept of damage). Instead, these definitions are ascertained by the judges. What is more, the Swiss Civil Code contains a lot of provisions where the legislator deliberately omitted to define all the factors that may play a role in a individual case and instructed the judge to complete the rule in his place (Art. 4 ZGB).[34]

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[29]BGE 131 III 33; BGE 135 III 20; BGE 139 III 283; Emmenegger and Tschentscher, N 194 et seqq.; Pichonnaz, pp. 207 et seq.

[30]It can also be explained by the multilingual character of Swiss Civil Code: the German, French and Italian version of the code have in principle the same weight (Art. 14 para. 1 PublG), which makes difficult to determine what is the litteral meaning of the law, cf. Emmenegger and Tschentscher, N 208 et seqq.

[31]Morin, p. 219; According to Eugen Huber, who wrote the Swiss Civil Code: "*The code must speak in popular ideas. The man of reason who has thought about his times and needs should have the feeling, as he reads it, that the statute speaks to him from the heart [. . .] The injunctions of the legislator must therefore, so far as the material permits, be comprehensible to everyone, or at least to those who are involved in the activities regulated by the statute. Its provisions must mean something to educated laymen, even it they will always mean more to the specialist*"; see original text in German in Huber, N 10; Zweigert and Kötz, p. 169.

[32]This is essentially this feature which explains the large influence of Swiss Civil Code in XXth century civil law codifications, and in international contracts, Morin, p. 219; Zweigert and Kötz, p. 175.

[33]Morin, pp. 219 et seq.

[34]Example: Art. 337 OR gives to the employer and the employee the right to terminate the employment relationship at any time "*for valid reasons*", without explaining what a valid reason is. Art. 4 ZGB orders the judge to complete this rule and define when there is a valid reason to terminate an employment contract without notice, cf. BGE 127 III 351.

The necessity of having a law as simple and practical as possible even led the Swiss legislator to give up the introduction of certain rules in the code. It was decided not to write a special rule for any situation in which the general principles founding private law could be used to find a solution, but instead to deal only with situations regarded as the socially most typical. For the other situations, the legislator delegated the competence to the judge to build a special rule, and thereby detailing the scope of a codification deliberately left incomplete, by taking into account the general system of private law and of its *ratio legis*.[35] This process still concerns the interpretation of the law (Art. 1 para. 1 ZGB), which must be understood in a very extensive way, and not the filling of legislative gaps (Art. 1 para. 2 ZGB). There should be a legislative gap only when the legislator *involuntarily* forgot to insert a solution in the law. Then, the judge must fill the gap *modo legislatoris* (Art. 1 para. 2 ZGB); indeed, if the legislator delegates to the judge the task to complete the code when it is led voluntarily incomplete, it is logical that he also gives, by extension, a creative power to the judge in the exceptional cases where there is a true gap in the law.[36]

The Limits of the Swiss Judge's Creative Powers

The great flexibility given to the Swiss judge in his application of the Swiss Civil Code does not mean that he can refer freely to the economic analysis of law in his interpretation of the rules written in the code (descriptive function of LAE) or in the creation of judicial rules (normative function of LAE).[37]

Because of the separation of powers and the principle of legality (Art. 5 BV), the Swiss judge cannot decide freely what the purpose of the law is. He must obey the choices made by the legislator (in principle the parliament, Art. 164 BV), whatever he thinks about them (Art. 190 BV). The judge cannot question the whole legal system in his interpretation of the law (Art. 1 para. 1 ZGB), or, by extension, through the filling of legislative gaps (Art. 1 para. 2 ZGB). His solution can take the social evolution into consideration, but only as far as it fits with the values and the system of positive law.[38]

Consequently, the judge can use LAE in Swiss contract law only if the legislator *really* decided that economic efficiency is the final purpose of this area of law.

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[35] Morin, pp. 219 et seqq.; Werro, N 43.

[36] BGE 74 II 106; Morin, pp. 219 et seq. and 224 et seqq.; see also Steinauer, N 363 and 369 et seq.; Werro, N 30 and 42 et seqq. *Contra* (but with similar practical results): Emmenegger and Tschentscher, N 367 et seqq. and 445; Kramer, *Methodenlehre*, pp. 184 et seq. and 282 et seqq.

[37] *Supra*, 9.1.1.

[38] BGE 129 III 656; BGE 123 III 292; BGE 126 III 129; Amstutz, pp. 318 and 322 et seq.; Emmenegger and Tschentscher, N 457 et seq.; Kramer, *Methodenlehre*, pp. 180 and 281 et seqq.; Martenet, p. 283; Morin, p. 230; Steinauer, N 324 et seqq. and 406 et seqq.; Werro, N 33.

9.3 Efficiency and the Declared Values of Swiss Contract Law

Swiss contract law contains no explicit reference to economic efficiency as its leading principle. Instead, Swiss law refers to the freedom of contract (Art. 11 and 19 OR) and good faith (Art. 2 ZGB). The Swiss judge must respect those legal principles when he deals with contract law (Art. 5 BV and 1 ZGB). The consequence is that he can take into account the concept of efficiency, as developed in the foreign context of US LAE, *only if this concept coincides with the combination* of freedom of contract *and of good faith at the basis of Swiss contract law*.[39]

9.3.1 Freedom of Contract and Efficiency

Freedom of contract is an expression of the fundamental right conceded to every person to organize freely the conditions of his life.[40]

The common law doctrine of consideration contained in US contract law allows in principle only onerous promises to be enforced. This is an implicit limit to freedom of contract, which may explain why, for some US scholars, freedom of contract normally leads to efficient solutions.[41] The same cannot be said about Swiss law, which allows in principle the parties to enter into contract about anything (Art. 19 para. 1 OR),[42] and thus recognizes the enforceability of gratuitous promises (Art. 243 OR).[43] So in Swiss law, freedom of contract will not necessarily lead to efficient solutions. From this concept, the contract is not only a market instrument, but also a way to contribute to the sense of meaning of a person's life (for example his need for a social status, of security and dignity; the realization of his affective interests, etc.).[44] Like others European legal systems, Swiss law especially takes into account the non-economic functions of contract law, because historically, modern civil contract law has been developed in reaction against feudalism.[45]

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[39] Cf. Eidenmüller, p. 171.

[40] BGE 129 III 42; BGE 129 III 276; BGE 131 I 333; Gauch, Schluep, Schmid and Emmenegger, N 612; Guillod and Steffen, N 4 et seqq.; Kramer, 'Kommentar', N 20 and 37 et seqq.; Oftinger, pp. 48 and 52 et seqq.; Wolf, pp. 10 et seq.

[41] Cf. Eric A. Posner, pp. 849–852.

[42] BGE 127 III 449; Belser, p. 28; Gauch, Schluep, Schmid and Emmenegger, N 618 and 624 et seqq.; Guillod and Steffen, N 48 et seq.

[43] BGE 105 II 15; BGE 136 III 142.

[44] Collins, *Contracts*, p. 30; Eidenmüller, p. 273; Guillod and Steffen, N 10, 13 and 26; Hesselink, p. 50; Whittaker, pp. 372 et seqq.; Wolf, pp. 8 et seqq.

[45] Huber, N 65; Belser, pp. 11 et seqq.; Kramer, 'Kommentar', N 21 et seqq.; Oftinger, p. 52.

9.3.2 Good Faith and Efficiency

In Swiss law, the principle of good faith (*Treu und Glauben*) is expressed in Art. 2 ZGB, which orders everybody to "*act in good faith in exercising his or her rights*"; that is, in a fair and correct way.

Some LAE authors misunderstand the role of good faith in civil law when they assert that this principle should be a default rule.[46] Like § 242 BGB, Art. 2 ZGB is what German lawyers call a *Generalklausel*, a meta-norm, which introduces ethical considerations in the implementation of the law. To quote the Swiss Federal Court, good faith "*limits any use of a right, to prevent the absolutism of the subjective rights, the dictatorship of the autonomy of the parties*".[47] Indeed, if fundamentally, individual freedom governs social relations, it follows that the legal order cannot save one person's freedom at the expense of other people's freedom, but everybody's freedom in an equal measure.[48] That is why, in Swiss law, the principle of good faith is seen as the *ratio legis* of private law, whose task is to preserve social harmony by giving the right balance (cf. Art. 36 para. 2 BV) between the individual existence of anybody and the collective existence of the members of the social body. The principle of good faith helps to find this ideal balance through the objective criterion of the consideration one must have towards everybody else.[49] Doing so, it also guides the judge when he must build or complete (cf. Art. 4 ZGB) a rule in the context of an open text codification and insert his solution into the existing legal system.[50]

When exercising this competence, the judge cannot solely refer to the abstract principle of good faith. He must concretize this principle, acting like the legislator would have done if he had written the rule himself in a general and abstract fashion, but still precise enough to be directly applicable to a concrete problem.[51]

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[46] Chirico, pp. 37 et seq.

[47] BGE 83 II 345.

[48] Belser, p. 166; Morin, p. 209.

[49] BGE 45 II 486; BGE 83 II 345; BGE 113 II 203; Hausheer and Aebi-Müller, N 23 et seq. and 66; Martenet, p. 249; Morin, pp. 209, 220 et seq. and 227; Zimmermann and Whittaker, pp. 30 et seq. Art. 2 ZGB is not especially original in its content. Art. 1132 of French Civil Code and § 242 BGB also refer to good faith, well known in Europe since at least *ius commune*. What makes Art. 2 ZGB original is that it expresses the principle of good faith in a very general way. When French and German law refer to good faith only in relation with contract law, Swiss legislator openly established this principle as the leading basis of whole private law. The Swiss civil Code asserts so the social vocation of private law, Morin, pp. 208 et seq.; Zimmermann and Whittaker, pp. 51 et seq.

[50] *Supra*, 9.2.2; Hausheer and Aebi-Müller, N 91; Emmenegger and Tschentscher, N 97 et seqq.; Morin, pp. 221 and 230.

[51] Hausheer and Aebi-Müller, N 64 et seqq.; Morin, pp. 227 et seqq. In practice, Swiss judges materialize Art. 2 ZGB mainly through analogy, because it is the safer way to insert their solutions in the existing legal system. They compare the individual problem they have to solve with similar situations already settled in written or judicial rules, necessarily deducted from good faith, as it is the *ratio legis* of any private law provision. This done, they can adapt those rules to the new situation and create by this way a new rule. Later, it is possible to establish typical groups of cases

Here again, some LAE authors wrongly limit good faith in civil law to "*examining the conditions for creativity material incentives for producing socially producing information at the lowest cost*".[52] When saying "*everyone must act in good faith in exercising his or her rights . . .*", Art. 2 ZGB limits individual freedom and at the same time protects it: everybody must exercise his or her private rights in a fair and correct way (limit of individual freedom), to respect everybody else's legitimate expectations (protection of individual freedom).[53] Those legitimate expectations cannot be limited to those of the *homo oeconomicus rationalis*. As freedom implies that fundamentally people can do what they want, what is legitimate is not necessarily what is economically efficient. Thus, good faith cannot be limited to efficiency, and the judge cannot refer to efficiency as a leading principle when he designs a rule. In Swiss contract law, good faith implies much more broadly that a party cannot in principle use her contractual freedom in a way that limits the other party's freedom against her will.[54]

As the *ratio legis* of written and unwritten Swiss contract law, good faith is the basis for the rule *pacta sunt servanda*. Fundamentally, freedom of contract implies that a party can ignore her promise if she no longer wants to be bound by it. This is unacceptable, because it would limit the other party's freedom against her will. Indeed, a contract builds a special relationship between the parties, where the creditor legitimately expects a correct performance from the debtor, because of the latter's promise. That can lead the creditor to take some measures (for instance, to promise to deliver the object of the performance to a third person), that would be useless, and thus damaging, in case of a breach of the contract. Consequently, good faith requires a limit of the debtor's freedom to protect the creditor's freedom by giving a binding effect to the contract and imposing to the creditor a fundamental duty of specific performance (Art. 68 ff OR).[55] By extension, good faith is also the basis of principles and exceptions derived from the rule *pacta sunt servanda*, such as warranty of the promissor and contractual damages understood as an equivalent to the specific performance (logical consequences of *pacta sunt servanda*),[56] or excuse in case of impossibility or frustration (exceptions to *pacta sunt servanda*, when unforeseen circumstances strongly modify the original balance of benefits).[57]

As another example, good faith also justifies the rules designed to ensure contractual fairness by giving to each party an equivalent influence in the design

(*Fallgruppen*) with the concretization of art. 2 ZGB, and infer from those groups more general and abstract rules, which will apply as a judicial codification to all new and similar cases, cf. Emmenegger and Tschentscher, N 376 et seqq. and 445; Morin, pp. 225 and 230 et seqq.; Steinauer, N 276 and 386 et seqq.; Zimmermann and Whittaker, pp. 22 et seqq.

[52] Schäfer and Ott, p. 375.

[53] Guillod and Steffen, N 25; Lurger, pp. 365 et seqq.

[54] BGE 133 III 449; Morin, pp. 214 et seqq.

[55] Hausheer and Aebi-Müller, N 4 et seq.; Morin, p. 215.

[56] Collins, *Contracts*, pp. 121 et seq.; Morin, p. 215.

[57] BGE 122 III 97; Hausheer and Aebi-Müller, N 225 et seqq.; Morin, pp. 214 and 232.

of the contract. For instance, it is the *ratio* of the rules aimed at protecting the interests of the party disadvantaged by a structural imbalance (for example in a contract B2C), by imposing on the other party a pre-contractual duty to disclose information relating to the contract under negotiation.[58] It is also the basis of the control of standard clauses (Art. 8 UWG, that refers explicitly to good faith). In those cases, good faith is necessary to correct the imbalance between the parties in a preventive and/or a corrective way, so that the material equality between them fits their formal equality, because freedom of contract implies that each party has the same power of decision. Here, the legal intervention is not focused on the content of the contract itself, but on the fairness of the contract formation process.[59]

9.4 The Limits of Efficiency-Oriented Reasoning When Dealing with a Swiss Contract

9.4.1 Efficiency as an Illegal Way to Alter Swiss Contract Law

The Consequences of the Absence of Coincidence Between Efficiency and the Declared Values of Swiss Contract Law

The previous analysis shows that freedom of contract and good faith, the two complementary principles at the basis of Swiss contract law, do not coincide with the concept of efficiency. They are much broader, because they are not focused on the object of the contract, but on the cooperation between the parties, to satisfy their mutual interests, *whatever goal they pursue*. That explains why Swiss contract law is basically indifferent to the objectives of the parties, with the rare exception of invalidity as a result of the contract goal being in violation of mandatory rules protecting one of the parties' interests – and thus finally deriving from good faith (e.g. Art. 100 OR; Art. 216 OR; Art. 27 and 28 ZGB) – or some public policy objectives (cf. Art. 19 para. 2 and 20 OR). That also explains why in principle Swiss law forbids a party to void the contract in the case of a mistake about the motives of their engagement (Art. 24 para. 2 OR).

Consequently, the recognition of efficiency as the final goal of Swiss contract law would seriously alter its rules, because contractual freedom and good faith would no longer be seen as the essence of contract law, but as tools in the service of efficiency.[60]

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[58] BGE 125 III 86; Gauch, Schluep, Schmid and Emmenegger, N 956 et seqq.

[59] Morin, 'Clauses', pp. 505 et seq.; Pichonnaz, p. 189; That shows that a legal system that combines individual freedom and good faith is necessarily concerned with distributive justice, cf. Mathis, p. 201; Eidenmüller, pp. 315 et seq.

[60] Bäuerle, pp. 271 et seqq.; Eidenmüller, pp. 404 and 457.

An indication of that can be found in the writings of one Swiss author, who relies on US LAE literature to develop solutions *de lege lata* that are different from those adopted by the Swiss Federal Court. This author asserts for instance that the party using standard clauses should not present them to the other party before the conclusion of the contract, because it would raise their transaction costs.[61] This solution is in opposition with the constant Swiss Federal Court position, which deducts a pre-contractual obligation of presenting standard clauses from the rules of offer and acceptance stated in Art. 1 ff OR,[62] and that is also in accordance with the idea of fairness in the contractual formation based on the principle of good faith. The same author defends the application of the Hand rule to determine if a party is guilty of a breach of contract (Art. 97 OR).[63] According to this rule, this would be the case when the marginal cost of avoiding the damage is less than the amount of the damage multiplied by the marginal probability of the occurrence of the damage.[64] The Swiss Federal Court has a different view: Negligence is given if, when causing prejudice, the author had not meet the standard of care that could be excepted in the circumstances of the case from a reasonable person sharing his typical characteristics, such as his age, his education, his profession or the risks linked to the performance (cf. Art. 321e para. 2 OR; Art. VI.-3:102 DCFR).[65] The Swiss Federal Court approach is logical in a legal system based on subjective rights (like individual freedom), that implies that there cannot be a strictly objective and abstract definition of a careful behaviour, based on the efficiency-oriented image of the *homo oeconomicus rationalis.*[66]

But if the declared values of Swiss contract law do not embed efficiency as a superior value, the alteration to Swiss contract law by submitting the principles of freedom of contract and good faith to efficiency would be against the principle of legality (Art. 5 and 190 BV), which commands respect for the values of positive law and the insertion of judicial solutions inside the system chosen by the legislator.[67] Therefore, *de lege lata*, it makes no sense to transplant LAE from the USA to systematically expose Swiss contract law and find out what it is.

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[61] Bieri, 'Possibilité', p. 204. This author considers quite surprisingly that the other party's interests would nevertheless be saved through the so called *Ungewöhnlichkeitsregel*, without realizing that this rule is the logical consequence of the rule about the presentation of the standard clauses, cf. BGE 119 II 443; BGE 135 III 1; Klett and Hurni, pp. 82 et seqq.; Morin, 'Clauses', pp. 519 et seq.

[62] BGE 77 II 154; BGE 100 II 200; BGE 119 II 443; BGE 135 III 1; Belser, pp. 283 et seqq.; Gauch, Schluep, Schmid and Emmenegger, N 1140 et seqq.; Klett and Hurni, pp. 80 et seqq. See also § 305 (2) BGB; art. 2.1.19 and 2.1.20 Unidroit Principles; art. II.-9:103 DCFR.

[63] Bieri, 'Responsabilité', pp. 521 et seq.; see also Seiler, pp. 144 et seqq.

[64] Bieri, 'Responsabilité', p. 521; Fikentscher, p. 17; Richard A. Posner, pp. 167 et seqq.

[65] BGE 117 II 563; BGE 120 II 148; BGE 130 III 193; BGE 133 III 124; BGE 137 III 359; Gauch, Schluep, Schmid and Emmenegger, N 2984 et seqq.; see also von Bar and Clive, pp. 3406 et seq.

[66] Oftinger and Stark, § 1, N 65 et seq.

[67] *Supra*, 9.2.2; Eidenmüller, pp. 422 et seq. and 437; Mathis, p. 204.

The Example of the Filling of Contractual Gaps

The filling of contractual gaps is an example of how the application of efficiency-orientated decisions would lead to different results, and is thus illegal if applied to Swiss contract law (on principles based on the combination of freedom of contract and good faith). It is a useful issue, because it is a problem that interests many LAE authors, and because there is no written provision about it in Swiss law, which means that the judge must build his own solution, acting as an ad hoc legislator.

There is a gap in a contract when its interpretation shows that the parties omitted to consider an issue connected to the execution (ex.: in a sales contract, the parties omitted to decide where and when the price has to be paid). A contract is also incomplete when it does not take into account all of the contingencies in the allocation of risks between the parties (ex: a sale contract does not explain what impact an increase of production costs of the good may have on the price).[68]

If there is no mandatory rule applicable to the problem and if the parties cannot agree on an addendum to the contract, the judge must fill the gap. In civil law as in common law, two methods are possible to supply a solution to deal with the omitted clause: an objective and a subjective one.[69]

- According to the objective method, the judge fills the contractual gap with what US scholars would call an off-the-rack or majoritarian default rule. It is a general and abstract rule, not specifically designed for the litigious contract (*Fremd-Norm*). This rule can be statutory (ex: a rule from the Obligation Code in Swiss law; in the USA, a rule from the UCC or the CISG) or judiciary (ex: a US rule extract from a leading case, such as the frustration of purpose doctrine based on the *Coronation case*; in Swiss law, the judicial principle of *clausula rebus sic stantibus*).[70]
- According to the subjective method, the judge fills the gap with a specific rule (*Eigen-Norm*), based on the hypothetical intent of the parties. To design that rule, the judge has to ask himself what solution the parties would have chosen if they had bargained over the matter.

It is difficult to choose between those two methods, and to some extent, to distinguish between them. The judge cannot use only the objective method and impose in every case a majoritarian default rule on the parties, because he has to take into account that contractual freedom allows them to contract around such a rule – as in fact, this is the norm in standard form contracts.[71] On the other side, he cannot exclude the use of any majoritarian default rule, even when using the subjective method, because the parties are free to chose that rule for their contract.

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[68] Collins, *Contracts*, p. 160.

[69] Amstutz, Morin and Schluep, N 39; Cohen p. 130; Mackaay, p. 429; Perillo, p. 141.

[70] *Krell v. Henry*, 2 King's Bench 740 (C.A. 1903) 182; BGE 127 III 300; Hausheer and Aebi-Müller, N 232.

[71] Collins, *Contracts*, pp. 228 et seqq.

The way LAE solve this problem can be summarized as follows: to fill the gaps in the contract, the judge should take as a guide the theoretical model of the complete contract. It is the contract that describes all the risks connected to the execution and allocates them in a way, which is advantageous for both parties. In other words: the judge must fill the gap in the contract in an efficient way. He has to do so because the parties inevitably desire a set of terms that will maximize the value of the exchange. LAE scholars assume that the goal of contract law is efficiency, and that it is also the goal of the parties. If they left gaps in their contract, it is mainly because of transaction costs. But if they had negotiated over the matter, they would naturally have chosen a solution according to the model of complete contract.[72]

So, according to LAE, the judge must fill the gaps in the contract with the rule that leads to an efficient solution.[73] If it is a statutory rule, he has to apply it. In other cases, he has to design a specific rule according to the goal of efficiency. The good default rule will allocate contractual risks to the party that can absorb them at the least cost (superior risk bearer), because it would have the last effect on the price.[74] For example, in the face of unexpected changed circumstances that give rise to an impossibility (ex: the rented house is destroyed by an accidental fire),[75] or impracticability (ex: there is a high rise of execution costs for one party, because of an unexpected event, such as a war)[76] a party should be excused from their contractual obligations if the other party is better able to prevent the risk from materializing, or if they were able to insure against the risk at a lower cost.[77]

In Swiss contract law, there is a discussion about how the judge should solve the conflict between the positive and the subjective method of filling contractual gaps.

The Swiss Federal Court and some authors consider that the objective method should prevail, unless there is no statutory default rule applicable directly or through analogy to the contract. In this case, the judge could apply the subjective method, which would only have a subsidiary function. This solution rests on the idea that statutory rules should have priority, because they are a result of a legislative process and are thus balanced and representative of the choices of reasonable persons.[78]

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[72]Crasswell, p. 89; Cooter and Ulen, pp. 227 et seqq. and 302 et seqq.; Polinsky, p. 29; Posner and Rosenfield, p, 89; Shavell, pp. 292 et seqq. and 339; with more nuances: Ayers and Gertner, pp. 92 et seqq. See also Kornet, pp. 289 et seqq., 315 et seq. and 366 et seq.; Hesselink, pp. 46 et seq.

[73]Cooter and Ulen, pp. 220 et seq.; Kornet, p. 316. Behavioral LAE use the same criterion, but taking into account that parties not necessarily act in a rational way, see Vandenberghe, pp. 412 et seqq.

[74]Cooter and Ulen pp. 220–222; Hesen and Hardy, pp. 84 et seq. and 89 et seqq.; Mackay, p. 429; Schäfer and Ott, pp. 280 and 299 et seq.; Smythe, p. 209.

[75]See for example *Taylor v. Caldwell*, King's Bench 1863, 3 B. & S. 826, 122 Eng. Rep. 309.

[76]See for example *Transatlantic Financing Corporation v. United States*, 363 F.2d 312 (D.C. Cir. 1966).

[77]Cooter and Ulen, pp. 221 et seqq. and 289 et seqq.; Eidenmüller, pp. 402 et seq.; Richard A. Posner, pp. 104 et seq.; Smythe, p. 209.

[78]BGE 113 II 49; BGE 119 II 368; BGE 127 III 300; Gauch, Schluep, Schmid and Emmenegger, N 1254; Hausheer and Aebi-Müller, N 125 et seq. See also Hesselink, pp. 63 and 83; Kramer, 'Kommentar', N 277.

This solution is criticized by others authors, as contrary to the fundamental principle that the parties can contract about anything (Art. 19 para. 1 OR). Indeed, with this principle, Swiss contract law allows the parties to escape the eventual distributive effects of default rules, which have consequently no indirect mandatory effect.[79] From this perspective, statutory default rules are at the service of the parties: they can use them if and only if they want to, with the advantage that it will reduce their transaction costs.[80]

Consequently, to fill a gap in the contract, the judge must in reality start with the subjective method. He must first determine if the parties would have chosen a statutory solution or instead designed a specific norm if they had negotiated over the matter. If the judge comes to the conclusion that the parties would have followed the rules of the code, he must fill the gap with the objective method. If he comes to the conclusion that they would have designed their own solution, he has to use the subjective method once again and fill the gap with a specific rule based on the hypothetical intent of the parties.[81]

Through out this process, the judge must take good faith as a guide, because Art. 2 ZGB orders him to assume that parties would normally behave according to this principle. He must then look for the most reasonable solution for the supposedly honest parties.[82]

But, and *that is where Swiss contract law diverges of LAE*, what is reasonable for the parties is not necessarily efficient, as contractual freedom allows them to contract about anything, even the most futile object (Art. 19 OR).[83] That is why the solution will always depend on all the concrete circumstances of the case, particularly the content of the contract and its goal.[84] The fact that contractual freedom allows the parties to do almost anything they want also explains why the judge will in principle not take into account the reasons why they left a gap in their contract.[85] So, depending on the concrete circumstances of the case, the judge will or will not apply a majoritarian default rule (based on good faith as *ratio legis*).[86] He will or will not allocate contractual risks to the party that can absorb them at the last cost (superior risk bearer). He never knows the right solution in advance, as he has to rely on the unique circumstances of each case.[87]

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[79] Kornet, p. 317.

[80] Kötz, pp. 10 and 177.

[81] Amstuz, Morin and Schluep, N 41 et seq.

[82] BGE 113 II 246; BGE 114 II 57; BGE 129 III 604; Hausheer and Aebi-Müller, N 126.

[83] *Supra*, 9.1.

[84] BGE 107 II 144; BGE 115 II 484; Hausheer and Aebi-Müller, N 126.

[85] See nevertheless Art. 2 para. 2 OR.

[86] *Supra*, 9.1.2.

[87] Collins, *Contracts*, p. 194; Eidenmüller, pp. 456 et seq.

9.4.2 *The Situations Where Efficiency Can Play a Role in a Swiss Contract*

Even if efficiency is not an objective value of Swiss contract law, there is some place for efficiency-oriented thinking when dealing with a Swiss contract.

First, the Swiss judge may take into account efficiency if it appears that both parties, using their contractual freedom, clearly want to reach efficient solutions, which may for example be the case in a contract between two commercial corporations. Here, efficiency plays the role of a *subjective* criterion helping the judge to define the parties' true will in the interpretation of the contract (Art. 18 OR) or the filling of its gaps.[88] But it would certainly not be the only criterion guiding the judge in this process because most of the time efficiency is not the unique objective of the parties.[89]

Therefore, the Swiss judge must take efficiency into account when submitting a contract to special legal rules that refer to efficiency. That is especially the case of the Federal Act on Cartels (*Kartellgesetz*), which explicitly promotes economic efficiency as one of the goals of competition law (Art. 1 and 5 KG).[90] According to the principle of legality (Art. 5 and 190 BV), the judge must apply this law even if it leads to different results than the implementation of the broader values of freedom of contract and good faith.[91]

In those cases where he has to deal with efficiency, the Swiss judge should take LAE literature into account with great care. It is true that he can follow the established doctrine when applying the law (Art. 1 para. 3 ZGB), including foreign ones.[92] But, for the moment, the economic analysis of contract law remains largely theoretical and limited to the academic field, with little influence on positive contract law,[93] and its methods and solutions are strongly criticized for relying on unrealistic and reductive assumptions and being impracticable.[94] So, one may wonder whether a Swiss judge can really consider LAE literature as an established doctrine. At any

[88] Eidenmüller, p. 458.

[89] *Supra*, 9.2.2.

[90] Martenet and Heinemann, pp. 37 et seq. and 94 et seq.

[91] Cf. Martenet and Heinemann, pp. 45 et seq. and 213 et seq. For example, it is more difficult to control standard clauses with Art. 7 para. 2 lit. c KG, based on efficiency considerations (cf. Art. 1 KG) than with Art. 8 UWG, based on fairness consideration typical of private law (cf. the explicit reference to good faith in Art. 2 and 8 UWG).

[92] Emmenegger and Tschentscher, N 475; Steinauer, N 442.

[93] Cf. the references quoted *supra* and footnote 1; Di Matteo, Prentice, Morant and Barnhizer, pp. 48 et seq.; Grechenig and Gelter, p. 297; Hackney, pp. 164 et seqq.; Eric A. Posner, pp. 868 et seqq.; Smith, pp. 133 et seq.; von Bogdandy, p. 3.

[94] See for example Ackermann, pp. 940 et seq.; Collins, *Contracts*, pp. 81 et seqq. and 118 et seqq.; Fezer, pp. 821 et seqq.; Hausman and McPherson, pp. 689 et seqq.; Hesselink, pp. 49 et seq.; Mattei, p. 244; Michaels, p. 794; Eric A. Posner, pp. 864 et seqq.; Stürner, pp. 22 et seq.; Oftinger and Stark, § 1 N.

rate, he should not refer directly to academic solutions developed in a foreign legal system, such as the US common law, but only use them as a subsidiary guide[95] to determine in a strict comparative approach the limited meaning of efficiency within the Swiss legal system.[96]

9.5 Conclusion

There have been numerous explanations for the relative success of the economic analysis of law in Europe compared with the USA, mostly based on arguments external to the law, such as the difference between legal education and legal research in the USA and in Europe.[97] Another important explanation may be the fact that too often, European scholars relate to LAE from a doctrinal perspective – that is to systematically expose the law and find out what it is – but take for granted that efficiency is really the final goal of civil contract law. This assumption is inaccurate, and could lead to misleading and finally illegal solutions, because efficiency is a belief, a priori no more universal than other value choices civil contract law may be based on. Efficiency has only a relative scope, and it may or may not be the leading value of civil contract law. That is why it is necessary (also from a comparative perspective) to check if the basic values of civil law coincide with the concept of efficiency, before doing any economic analysis of civil contract law in a doctrinal perspective.

In Swiss contract law, this leads in substance to the following observations: Freedom of contract and good faith are the two complementary principles Swiss law refers to as the leading values of contract law. They have a much broader field than efficiency, so that the application of efficiency-orientated decisions in Swiss contract law would lead to different results than the development of solutions based on the combination of freedom and good faith. Even if Swiss law gives a great flexibility to the judge, the separation of powers and the principle of legality forbid him to change the values and the system of positive law; in particular, he cannot narrow the scope of freedom of contract and good faith in favour of efficiency. Therefore, *de lege lata*, it makes in principle no sense to transplant LAE from the USA and to then look at Swiss contract law in a doctrinal perspective.

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[95] Emmenegger and Tschentscher, N 480.

[96] Fikentscher, pp. 16 et seq. and 117; Hatzis, pp. 176 et seqq.; Mattei, *Law and Economics*, pp. 69 et seqq. See also Michaels, pp. 786 et seq. and 792 et seq.; Peyer, pp. 110 et seq. This approach coincides with the limits of the influence of European law in the interpretation of Swiss law in the case of an autonomous adoption of European law, cf. ATF 129 III 335. Indeed: if an interpretation of Swiss law in the sense of European law is possible only inside the methodology of Swiss legal order, that should be all the more imperative when trying to use in Swiss law some theoretical developments from the field of common law.

[97] Garoupa and Ulen, pp. 1619 et seqq.; Grechenig and Gelter, pp. 304 et seqq.

These observations could well be quite typical of the limited influence LAE may have in the application of positive civil contract law, because of the representative character of Swiss contract law, thanks to its openness to legal transplants, and, at the same time, its influence as a legal transplant. And indeed, there is some evidence that other legal systems in continental Europe base their contract law on values similar to the broad concepts of freedom of contract and of good faith used in Swiss law, and also forbid the judge to reduce freely the scope of these values in favour of the narrower concept of efficiency, anyway as far as they relate to fundamental rights.[98]

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[98] See for instance Ciacchi, pp. 304 et seqq.; Busch and Schulte-Nölke, pp. 27 et seq.; Mak, *Fundamental Rights*, pp. 25 et seqq.; Whittaker, pp. 372–380; Whittaker and Zimmermann, pp. 700 et seq. Further, see Michale Bäuerle, *Vertragsfreiheit und Grundgesetz*, and Horst Eidenmüller, *Effizienz als Rechtsprinzip*, for a detailed analysis of German law.

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Chapter 10
Class Action Lawsuits in Europe: A Comparative and Economic Analysis

Ricardo Dawidowicz

Abstract In this essay I would like to outline and analyse various options for structuring a class action lawsuit. First, I will examine the form of class action lawsuit that is best known internationally, the United States of American class action, with a view to showing the extent to which its negative impacts are linked to particular institutions of US law. I will proceed to examine European forms of collective legal protection that are thought to be appropriate to today's needs. The subsequent economic analysis sets out to evaluate the different possible structures for class action lawsuits with reference to the goal of economic efficiency.

10.1 Introduction

For a number of decades now, economic and social change has been taking place on a vast scale. Over the same period, cases have arisen with increasing frequency in which a multitude of people suffer economic harm due to identical or very similar incidents. Catchwords such as globalisation, mass production, global financial markets, mass transportation and mass communication are now firmly embedded in our vocabularies. They denote phenomena which are directly related to the upsurge in diffuse harms, and which have changed society's needs and expectations vis à vis the prevailing codes of civil law and rules of civil procedure. For some years class action lawsuits have been a contentious topic of debate in Europe as a possible solution to the problem. In most countries with civil law systems, despite a growing need for collective legal protection and definite awareness of the advantages of grouping similar claims, there are strong reservations about class actions. Antipathy towards class action lawsuits is equally widespread among legal practitioners, the

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underlying rationale being a deep-seated fear of US-style class action lawsuits and their detrimental economic impacts in that jurisdiction. In general, the term "class action" calls to mind an institution which, in the USA, has brought about conditions most notable for excessive proceedings and sometimes exorbitant sums of damages. Nevertheless, the procedural law institution of the class action must always be contextualised in the wider societal reality that contributes substantially to defining its function. Impacts of the class action on US industry are not the result of class action lawsuits per se, but arise in conjunction with a combination of US legal instruments (known as the toxic cocktail). Now the same realisation appears to be gaining ground in Europe, and efforts by various EU Member States to improve collective legal protection testify to the endeavour to address dispersed and mass harms more effectively without necessarily importing the drawbacks of the US-style class action.

10.2 Collective Legal Protection in the Form of Collective Lawsuits

In contrast to the USA where the class action is a firm element in the rules of civil procedure, different forms of collective legal relief have (hitherto) prevailed in continental Europe. The lawsuit brought by an association (Verbandsklage), as a means of grouping similar interests, is especially widespread. In lawsuits brought by an association, one organisation or public authority – usually with ex ante authorisation – brings proceedings in the name of the affected parties.[1] Lawsuits brought by associations are only effective inter partes, i.e. between the plaintiff association and the respondent. A further difference from the class action lawsuit is that lawsuits brought by associations can only demand the cessation, abatement or determination of a breach of law but not the enforcement of damages claims or redress for the affected individuals.

10.2.1 Scope of Application

Collective lawsuits have certain advantages compared with individual lawsuits, especially in the area of dispersed harms. These are harms which can be substantial in total but minor to the point of insignificance for each individual affected.[2] In these cases, civil proceedings are rarely brought in the form of individual lawsuits, since the poor cost-benefit ratio of a lawsuit leaves plaintiffs unmotivated to pursue their claims (also known as "rational disinterest" or "rational apathy"). The cost-

[1] Van den Bergh and Keske, p. 20.

[2] Wagner, p. 52.

benefit ratio of a collective lawsuit differs markedly from that of an individual lawsuit. Depending on its precise structure, a collective lawsuit can avert the rational disinterest of potential plaintiffs (with varying degrees of success).

Among the domains in which dispersed harms occur is competition law. Monopolies can result in consumers having to pay a price in excess of the free market rate. This not only harms the individual buyer but also leads to a macro-economic welfare loss. Similar issues arise with cartels and companies in market-dominant positions. It is in the macro-economic interest that the individual affected parties should assert their rights, but rational disinterest prevents them from doing so. Even in the domain of consumer protection and product liability, individual interests and the macro-economic interest in litigation are frequently at odds.[3] Here again, collective legal protection offers considerable advantages from a welfare-economic perspective.

Collective lawsuits can also be applicable in instances of mass harm. Admittedly, the harm suffered by a multitude of people due to a mass incident is far from trivial. Nevertheless, because the number of affected parties often runs into thousands, efficient management of the ensuing avalanche of lawsuits is problematic.[4] The cases resulting from the collapse of Lehmann Brothers bank in 2008, at the height of the financial crisis, were a classic example. Thousands of Lehmann bondholders lost money due to the bad advice they received. A flood of individual lawsuits on that scale is grotesque from the viewpoint of procedural economy.

10.2.2 Possible Structures of a Class Action

Different legal systems and rules of civil procedure have brought forth numerous and highly diverse forms of collective legal protection. One thing that often makes it difficult to gain an overview is the absence of harmonised terminology. The structuring of an institution that brings together similarly-aligned interests poses some fundamental questions at the outset, which will be presented below.

The procedure for a class action lawsuit, as with any suit, begins with the filing of a lawsuit by the claimant. In taking this step, the affected party is suing not only in his own interest, however, but also on behalf of all other parties similarly affected. This occurs without having been authorised by the affected third parties. Only in the next step do the affected third parties decide whether they want to be parties to the proceedings. Under an opt-in procedure, affected third parties who have not filed suit themselves must expressly confirm their participation so that the proceedings can have legal effect on their behalf as well. In contrast, under an opt-out procedure, affected third parties remain parties unless they expressly declare their withdrawal. If they fail to do so, they are then obligatory members of the group of represented

[3] Van den Bergh and Keske, p. 20.

[4] Wagner, p. 54.

parties and have no option to withdraw.[5] The number of participants in proceedings varies depending on the form of proceeding. Typically, the opt-out solution leads to a larger group of represented parties. At the same time, this solution harbours the risk that affected third parties might be legally bound without even knowing that a lawsuit has been filed.[6] A system whereby affected third parties are obligatory participants is also perfectly conceivable, and this solution is certainly advantageous with regard to the size of a plaintiff group.

Opt-out procedures, and particularly models without any option of withdrawal, bring serious legal problems in their wake. They infringe on legal due process and the claimant's right to determine for himself whether he wishes to litigate his claim. Within the continental European conception of civil law, it is problematic to allow people who have not actively asserted their claims to participate in the award or settlement sum.[7]

10.3 The US-Style Class Action and the Toxic Cocktail

10.3.1 Rule 23

In the USA the class action was introduced in 1938 under Rule 23 of the Federal Rules of Civil Procedure, and has been a firm component of civil procedure since the full introduction of the revised Rule 23 in 1966. The aim was straightforward: to group the interests and resources of people with claims based on the same or similar causes and addressed to the same person. The scope of application has broadened over time and today encompasses civil rights, health protection, consumer protection, environmental protection and other domains of law.[8] In order to bring a class action, a court's permission is required. Permission is granted if four main prerequisites are met cumulatively: there must be a minimum number of claimants; some question(s) of law or fact must be common to the claims of all members of the class; the claims of the party representing the class (the lead plaintiff) must typify the interests of the class as a whole; and it must be ensured that the class representative will protect the rights of the class appropriately.[9] The class action is thus a representative lawsuit which the lead plaintiff litigates in the name of all group members, known or unknown. The common questions of fact and law are determined uniformly for the entire group of people affected by the legal issue at dispute. Therefore the proceeding also has legal effects for persons who have not joined the lawsuit or are not even aware of it; thus, it is an opt-out procedure. When

[5] Van den Bergh and Keske, p. 18.

[6] Eichholtz, p. 10.

[7] Droese, p. 121.

[8] Batten, pp. 440 et seq.

[9] Hohl, pp. 23 et seq.

the proceeding ends in a settlement or judgement, the only claimants not affected are those who have expressly declared their withdrawal from the plaintiff group.[10]

10.3.2 Punitive Damages

The impacts engendered by class action lawsuits are dependent on their wider societal context, including peculiarities of the given legal system. A particular feature of US law is the existence of punitive damages. Combined with the US court-costs and jury system, punitive damages create a climate that favours plaintiffs. This is desirable in the USA where the compensatory function performed by tort law is necessary to counterbalance shortcomings of the US social security system. A plaintiff-friendly climate is essential to the fulfilment of this compensatory function, because otherwise access to the legal system would be more or less impossible for most plaintiffs.[11] In continental European jurisdictions there is controversy as to whether punitive damages can be classified as a civil matter.[12] Due to their punitive and deterrent function, parts of the doctrine categorically rule this out.[13] The punitive damages system has a direct bearing on the (by European standards, excessive) damages sums awarded in American class action lawsuits.

10.3.3 The American Rule

According to the European rule (also known as the English rule), losing parties basically have to pay all legal expenses. Likewise, they have to compensate their opponents for the full cost of their legal representation. If a party only loses part of the case, court costs are split between the parties in proportion with the outcome. Compensation awarded to either party is reduced accordingly. If the ruling is half-and-half for both parties, neither party owes the opponent any compensation. If a case is won on all counts, the losing party has to pay all court costs and the winning party's legal fees in addition to their own legal representation fees.[14] The enormous resulting cost-risk presents a significant "barrier to litigation".[15]

A contrast to the European rule is seen in the costs rule of US civil procedure (known as the American rule). According to this rule, the losing party bears the court costs. Nothing is stipulated as to who pays the lawyers' fees. Essentially the

[10] Batten, pp. 440 et seq.

[11] Hohl, p. 50.

[12] Fritz, pp. 9 et seqq.

[13] Mörsdorf-Schulte, p. 297.

[14] Cf. Sutter-Somm, nos. 436 et seq.

[15] Baudenacher, pp. 173 et seqq.

parties must meet their costs of action themselves.[16] In most states it is not possible to shift the costs onto the losing defendant. An exception is made in certain cases where a party has committed serious breaches of procedural obligations.[17]

In the context of collective lawsuits too, cost-allocation rules have an influence on the decision-making behaviour of the parties involved. Initially the cost-shifting of European legal systems has effects on the decision of a possible plaintiff to assert his claim in court. Shavell assumes that cost-shifting leads to a greater propensity to litigate in situations where the plaintiff has a strong probability of winning, due to the equally strong likelihood of not having to pay lawyers' fees. Conversely, the shifting of costs might lead to fewer lawsuits being brought in situations where the plaintiff is unlikely to win. However, Shavell argues, this is only true if the claimant is assumed to be risk-neutral; where the claimant is risk-averse, a lawsuit is less likely, since the riskiness of a court case is increased by the fact that the total costs of action depend on the outcome of the proceedings.

The cost-allocation rule also has consequences for the claimant's choice between a settlement and court action. According to Shavell, the European rule on costs has a fundamental tendency to increase the likelihood of court proceedings.[18]

10.3.4 Contingency Fees

A further difference that exists mainly between the European and the American legal systems is the payment of the lawyers' fees. Contingency fees are not unusual in the USA and are usually set at up to 30 % of the award or settlement sum.[19] The size of this percentage is derived from the risk of losing the case and with reference to the rates of other common forms of fee.[20] If the interest of the client is better served by another form of fee arrangement, the lawyer is obliged to give advice accordingly, pointing out the respective financial consequences, and (where appropriate) to refrain from agreeing a contingency fee.[21] Since there is no state-organised legal aid system for those without financial means in the USA, contingency fees substitute for the function of free administration of justice. A contingency fee arrangement enables the parties without financial resources to litigate, even against well-financed opponents, without upfront costs and financial risk.[22]

The fee arrangement has an influence on incentives to which lawyers may be subject when deciding whether to accept or refuse particular cases. A comparison

[16] Neufang, p. 31.

[17] Adams, *Ökonomische Theorie*, p. 349; cf. Adams, 'The Conflict', pp. 53 et seqq.

[18] Shavell, pp. 429 et seqq.

[19] Böhm, p. 68.

[20] Neufang, p. 31.

[21] Böhm, p. 68.

[22] Neufang, p. 31.

of pure hourly fee arrangements with pure contingency fee arrangements shows that, measured by the objective of maximised remuneration, and where the American rule applies, there are higher incentives to accept cases on an hourly fee basis than for a contingency fee.

Further, the cost-allocation rules influence the lawyer's incentives to steer the client down the litigation route or towards accepting a settlement. Here, too, Shavell concludes that, measured by the objective of maximising his expected profit – minus court costs – the lawyer under an hourly fee arrangement will have a far stronger tendency to go to court than under a contingency fee arrangement.[23]

10.4 The European Class Action

10.4.1 Collective Legal Protection at National Level

Turning attention to the EU Member States, it is easy to discern efforts in the direction of collective instruments of legal protection with similarities to the institution of the class action lawsuit. Collective instruments of legal protection exist in around half of EU Member States. In the past decade, for example, Nordic countries like Sweden, Norway, Finland and Denmark have introduced class action-like lawsuits into their legal systems. Many Member States in which such instruments have not yet become established are either at an experimental stage or are considering whether they should be introduced.[24] The next section will list some examples of a European trend in the direction of class action lawsuits.

Germany

Germany introduced the Capital Investors' Model Proceedings Act (Kapitalanlegermusterverfahrensgesetz, KapMuG) in 2005 for a trial period of 5 years. Under proceedings of this kind, questions of fact and law that require clarifying for several trials are determined uniformly.[25] A prerequisite of a minimum of ten plaintiffs is stipulated. From among these, the court appoints a model plaintiff; all other plaintiffs take the role of interveners. The judgement has binding effect on all parallel proceedings and applies to both the model plaintiff and the interveners.[26] In order to join the model proceedings, however, every injured party must lodge a claim. It is notable that a settlement can only be concluded if all parties consent to

[23] Shavell, pp. 435 et seq.

[24] Janssen, p. 6 et seq.

[25] Michailidou, p. 234.

[26] Hess, p. 2331.

it. This makes any legal blackmailing (see below) practically impossible.[27] After a 2-year extension to its duration in force, the law will become invalid at the end of October 2012.[28]

England

In England, an additional form of collective legal protection called the group litigation order (GLO) was introduced in 2000.[29] A judgement regarding common questions of law and fact carries legal force for all registered parties. After the opening of a group register, other persons can opt in to the proceedings. Proceedings already pending can be referred, adjourned or registered and integrated into the group register. GLOs are also intended to help persons to lodge a claim whose individual amount in dispute is relatively low, and who would otherwise refrain from pursuing the issue due to the high costs of court action in England. Plaintiffs who have not had themselves registered in the group list can continue to pursue their cases independently of the GLO and any decision reached in it.[30]

Spain

Along with a new code of civil procedure (LEC), Spain introduced a hybrid form between a group lawsuit and proceedings brought by an association in the sphere of consumer protection.[31] If affected consumers are known, or can be traced without unreasonable effort, both consumer protection groups and groups of injured parties are entitled to assert claims. The ruling obtained by one group of affected parties only has effect among those parties already participating in the proceedings, but not for other injured parties. If the affected consumers are not identifiable, however, or not without undue difficulty, then only selected "representative" consumer protection organisations are entitled to assert claims. In this regard, consumers who have not taken part in proceedings are legally bound to accept the ruling.[32] The Spanish solution contains an interesting alternative to Rule 23. Accordingly, all potential plaintiffs must be notified by appropriate means before the claim can be brought. As soon as the lawsuit is filed, it is publicised in the media. The distribution of the amount sued for also differs significantly from Rule 23. Those identified as parties to the proceedings or readily identifiable persons entitled to damages are individually designated in the court judgement (collective damages). For those who

[27] Dahm-Loraing and Speer, p. 16.

[28] Cf. <http://www.gesetze-im-internet.de/kapmug/BJNR243710005.html>.

[29] Dahm-Loraing and Speer, p. 16.

[30] Dahm-Loraing and Speer, p. 8.

[31] Cf. Droese, p. 127.

[32] Droese, p. 129.

cannot readily be identified, the court judgement must describe the characteristics of the beneficiaries and define criteria for identifying them (general damages). Persons who do not belong to the claimants' group have 5 years to seek enforcement of the court's judgement.[33]

Sweden

A Swedish variant of a class action lawsuit entered force on January 1, 2003. It allows both desist and payment claims and is not restricted to consumer law or environmental protection but also applicable to goods and services. Other conditions must be fulfilled cumulatively before such a claim can be filed. First, common questions of fact must be present. Furthermore, the claim must be controllable; any better solutions, such as joining of actions or test lawsuits, must be unavailable. Moreover, the case must be sufficiently defined. The names and addresses of all group members must be mentioned in the statement of claim, in case this information is necessary for the processing of the case. In addition, the plaintiff must be suitable to represent the class.[34] Unlike Rule 23 in the USA, a potential group member must actively opt in to membership of the plaintiff group. Only persons who took up this option by notifying the court are bound to accept the court's ruling in this case. The opt-in proceedings were chosen due to the fear that an opt-out procedure could include people in the lawsuit who were unaware of it; a clear violation of a principle of Swedish law whereby individuals may decide for themselves whether or not they wish to take legal action.[35] The court must inform group members about the institution of the class action lawsuit, the court's judgement or any settlement. The court has a comprehensive duty of confidentiality.

The class action lawsuits brought to date since the possibility was introduced have been of a commercial nature, for the most part. One example is a class action by airline passengers who were forced to buy new tickets for the return flight, and by insurance policy holders who claimed that an insurance company had violated fiduciary duties.[36]

10.4.2 Collective Legal Protection at EU Level

Discussions on the introduction of class action lawsuits or class-action-like institutions at EU level have now been in process for some time. The EU Commissioner

[33] Harbour and Shelley, p. 28.

[34] Mattil and Desoutter, 'EC Law', p. 485.

[35] Proposition 2001/02:1070064, 8.

[36] Cf. Harbour and Shelley, p. 27.

for consumer protection considered introducing consumer claims and class action lawsuits as part of the "EU Consumer Policy strategy 2007-2013".[37] After the Green Paper from the year 2005[38] the European Commission took major steps in the direction of collective legal protection in 2008 when it presented its White Paper on "Damages actions for breach of the EC antitrust rules"[39] in the field of cartel law. As well as lawsuits brought by associations, this would have opened up the additional possibility of an opt-in group lawsuit. Within this framework, individual victims could have joined forces to group their respective damages claims within a single lawsuit.[40] According to the Green Paper, consumer protection law was another potential sphere of application for class action lawsuits.[41] While the Commission had decided on an opt-in procedure in cartel law, elements of an opt-out class action lawsuit were also considered. One variant discussed was that of a split opt-in/opt-out solution. Where smaller amounts of damages were concerned (up to EUR 500, for example), the consumer would have been permitted to opt out on the basis of the rational disinterest problem. For amounts of damages above that level, an opt-in procedure would have been made available.[42] A pure opt-out solution on the model of the US class action was generally avoided, out of fear of negative impacts. The proposal for a Directive put forward by the Directorate General for Competition of the EU Commission was stopped in 2009. On February 4, 2011, however, the EU Commission published a renewed consultation on the theme of class action lawsuits. In the course of its public consultation, the Commission wants to try and determine common principles of law for collective legal protection in the EU.[43]

One difficulty is that "European" cost-allocation rules prevail in most EU Member States. As a possible consequence, consumers and even consumer associations might not wish to participate in class action lawsuits. In cases involving dispersed harms with a total value in the millions, this is all the more problematic (as in the much-discussed "o2 case"[44]). One solution might be the possibility that private claims financiers take on the court-costs risk and, in return, receive a share of the sum awarded in the event of success.[45] This solution is viewed with scepticism, however, since it is associated with the US-style class action and the "class action industry" that predominates in the USA.[46] Equally, there are warnings that unjustified claims will escalate if consumers are freed from the court-costs

[37] KOM(2007) 99 final, 03.03.2007.

[38] KOM(2005) 672 final, 19.12.2005.

[39] KOM(2008) 165 final, 02.04.2008.

[40] White Paper, pp. 4 et seq.

[41] Green Paper, p. 11.

[42] M.w.V. Janssen, p. 12.

[43] <http://www.muenchen.ihk.de/mike/ihk_geschaeftsfelder/recht/Vertragsrecht/EU-Sammelklagen.html>.

[44] Cf. Janssen, p. 13.

[45] Green Paper, p. 15.

[46] Janssen, p. 13.

risk.[47] A further obstacle to the use of collective legal protection is felt to be the level of lawyers' fees. Any discussion of this problem must be set in the context that, in most EU Member States, contingency fees are prohibited to a greater or lesser extent.[48]

10.5 Economic Analysis of Law in Relation to the Class Action Lawsuit

The role of impact analysis in the legislative process is generally undisputed.[49] In the United States, for example, cost-benefit analyses have long been standard practice in relation to major new regulations. But impact orientation is also largely accepted in Europe, and since 1995 the OECD has recommended its member countries to carry out "Regulatory Impact Analysis" (RIA) as part of the legislative process.[50] At European Union level, too, impact analysis is prescribed for important legislative proposals.[51] In the context of application of law, impact orientation is not accepted in the same measure. Whether it should also be considered in the adjudication process is a matter of controversy.[52]

Economic analysis of law is a central element of regulatory impact analysis. The arguments in favour of the class action lawsuit, dealt with in Anglo-American literature for the most part, are by nature arguments from the economic analysis of law. Efficiency benefits of class action lawsuits over individual lawsuits are also measured with particular regard to their deterrent effect. It is a prospective view. At the forefront is the effect of the rule or the prejudicial effect of the resulting judgements on the future behaviour of all norm-addressees.[53] It makes potential perpetrators of harm aware that even if the individual harms they cause are minor, they will be held accountable for the harm they cause. The aim is also to set the right incentives to promote cost-effective behaviour both among potential perpetrators of harm and among those affected. Ultimately this should maximise social welfare. This approach is by no means uncontroversial, and is open to the objection that hypothetical damages cases are being analysed ex ante with a view to cost and risk minimization, whereas in reality, a court has to rule ex post on real cases of harm

[47] Green Paper, p. 16.

[48] Mattil und Desoutter, 'Sammelklage', p. 526.

[49] Mathis, *Efficiency*, pp. 204 et seq.

[50] Mathis, 'Consequentialism', p. 4.

[51] Bundesministerium des Innern, Der Mandelkern-Bericht – Auf dem Weg zu besseren Gesetzen. See also: Andrea Hanisch, *Institutionenökonomische Ansätze in der Folgenabschätzung der Europäischen Kommission*.

[52] Cf. Mathis, 'Consequentialism', pp. 3 et seq.

[53] Cf. Mathis, 'Consequentialism', p. 6.

involving very specific parties, who are drawn into a normative relationship with one another based on the case at issue. The normative relationship between the parties thus cannot be explained within the framework of the analysis (also known as the "bilateralism critique").[54] Here the question that arises is whether, in conducting the analysis, one should assume that the legal relationship between the perpetrator and the victim of harm is bilateral in nature (in keeping with the concept of corrective justice), or whether one should take one's orientation from a societal goal, namely the promotion of efficiency (in keeping with economic analysis of law). The next section looks at the arguments from the viewpoint of economic analysis of law in favour of a class action lawsuit.

10.5.1 Unjustified Advantages of the Defendant and the Use of Economies of Scale

If the defendant is confronted with a series of separate lawsuits based on the same questions of law or fact, then he will treat the plaintiffs as a de facto class. Consequently the defendant will endeavour to minimise his liability towards the plaintiffs as a group. By virtue of the fact that he can treat the claims of the individual plaintiffs as a unitary dispute, the defendant then has an "artificial", unjustified advantage over the individual claimants. If claims are processed separately, the defendant – but not the plaintiffs – can make use of economies of scale, thus automatically benefiting from a better position at the outset. The defendant can naturally invest resources in clarifying common questions of law or fact, the returns from which can be utilised in each of the individual cases. Thus he can invest on a scale that the plaintiffs cannot match, economically. An asymmetry arises between the defendant and the plaintiff who does not enjoy this advantage. A party to the lawsuit will invest up to the point at which the costs of additional investment exceed any profit from it. A lawyer representing a certain plaintiff (or a small group of plaintiffs with a common interest) reaches this point before the defendant does.[55] The above can be illustrated with a numerical example.

Let us assume a hypothetical product liability case in which 1,000 plaintiffs are involved, each of whom suffered damage to the value of EUR 1,000. The defendant is threatened with potential damages claims of EUR 10,000,000. Assuming, however, that no single lawyer represents more than 10 plaintiffs, there is no more than EUR 10,000 at stake on the counterparty side. Consequently the defendant will invest more than the plaintiff, and his chances of winning the argument on similar questions become greater than the plaintiff's, who does not have the same investment incentives. For the defendant, the potentially greater losses can thus be

[54] Coleman, p. 16; cf. Mathis, *Efficiency*, p. 78.

[55] Hay and Rosenberg, p. 1383.

used as a lever to increase the probability of victory. This insight applies by analogy to practically every kind of investment with regard to questions of law that are common to all plaintiffs.[56]

The outlined problem is distinctly less severe if the plaintiffs' claims can be grouped into a class action lawsuit. A plaintiff group that has claims amounting to EUR 10,000,000 will (if they share costs) be prepared to invest more, collectively, than if they were seeking to make individual claims of EUR 1,000 each. Class action lawsuits thus neutralise the economic asymmetry by enabling plaintiffs to use economies of scale in the same way as defendants can. Expenditure on similar grounds must be activated once only, either saving money or releasing it for further court expenses. Class action lawsuits therefore enable plaintiffs to invest more productively. These investments can influence both the likelihood of winning and the size of the compensation amount.[57]

10.5.2 Procedural Efficiency

A further argument in favour of the class action lawsuit is that of procedural efficiency. It includes the economies of scale argument to a certain extent but its main focus in general is on court costs, which are arguably lower than the costs of numerous individual cases. It must be borne in mind, however, that the grouping of interests only generates true economies of scale if enough individual lawsuits would have been brought in place of the class action lawsuit.[58] Depending on the case being adjudicated and the precise structure of the class action lawsuit, it may equally well be associated with higher costs than a traditional individual lawsuit. Class action lawsuits demand legal control mechanisms which require greater intervention from lawyers; hence additional costs are incurred.[59] These extra costs must be set off against any cost savings. Cost savings vary depending upon whether it is an opt-in, opt-out or an obligatory class action procedure. Class action lawsuits without a withdrawal option ensure the greatest procedural efficiency, provided that the factual and legal questions are common to all cases. If the legal questions differ substantially from the case to case, the savings and hence the procedural efficiency will be lower.[60]

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[56] Hay and Rosenberg, p. 1385.

[57] Hay and Rosenberg, p. 1383 et seq.

[58] Van den Bergh and Keske, p. 26.

[59] Scottish Law Commission, Multi-Party Actions, Report under a reference under section 3(1) (e) of the Law Commissions Act 1965, Edinburgh 1996, No. 154, p. 42, <http://www.scotlawcom.gov.uk/downloads/rep154.pdf> (viewed 14 September 2010).

[60] Van den Bergh and Keske, p. 26.

A further argument supporting the procedural efficiency of class action lawsuits is that they frequently lead to a settlement out of court.[61] All parties save costs as a result of an out-of-court agreement. The proportion of out-of-court settlements resulting from a class action is as high as 90 % in the USA.[62] Likewise the Austrian and Swedish forms of class action lawsuit result in settlements in the majority of cases.[63] It is questionable, however, to what extent a settlement counteracts the deterrent effect of the class action lawsuit. This might depend upon whether the settlement arrives at a similar result as might be expected from a court ruling.[64]

10.5.3 Deterrent Effect of the Class Action Lawsuit

Society's interest in the prosecution of breaches of law can diverge from the interests of private individuals. As a consequence of class action lawsuits, the costs (of lawyers, courts and experts) are dispersed among a large number of individuals, which means a reduction in the individual's expected costs and a corresponding reduction in rational disinterest. Similarly, a class action lawsuit disperses the risk of litigation among many people, which can be of particular importance under the European cost-allocation rule. This can lower the inhibition thresholds to bringing a lawsuit and increase the use of litigation. Consequently, the deterrent effect is also heightened.[65] Empirical studies on this matter have demonstrated a systematic correlation between a decrease in costs to be borne by the individual and an increase in the number of persons represented within the framework of a class action lawsuit.[66]

In relation to the deterrent effect, too, differences exist between an opt-in and an opt-out procedure. Only once the number of participating affected third parties exceeds a certain minimum number does an opt-in class action lawsuit make sense for the initiator of the lawsuit. Whereas affected parties with relatively large damages tend to take part in the class action lawsuit, in the case of dispersed harms on a very small scale, the incentives for participation can still be too low. Having to contribute to the costs can put off affected parties whose damages are only minor. It must also be noted that the opt-in procedure makes it extremely difficult for the initiator of the lawsuit to assess the costs and risks. Only after expiry of the permitted opt-in period does the number of parties with whom these are to be shared

[61] Van den Bergh and Keske, p. 27.

[62] Bohn and Choi, p. 903.

[63] Piker-Hörmann and Kolba, pp. 199 et seq.

[64] Van den Bergh and Keske, p. 27.

[65] Van den Bergh and Keske, p. 22.

[66] Eisberg and Miller, p. 27.

become apparent. This unpredictable element could equally deter affected parties from bringing a class action lawsuit.[67] Thus, an opt-in procedure does not produce an optimal solution to the problem of rational disinterest.

One potential solution would consist of having the costs and risks borne by a third party. This role might be fulfilled by lawyers, professional court cost financiers, or legal protection insurance policies. The consideration for bearing the risks and costs of the court action might consist either of a share of the damages payment or an insurance payout. A further potential solution might be the possibility of contingency fees, which would also give lawyers incentives actively to seek out breaches of law and bring them to trial.

In the case of opt-out class action lawsuits, the situation is different. The represented group is more extensive to begin with, and little use of the opt-out option is likely to be made.[68] Evidence of this has been shown by relevant US studies.[69] Therefore, unlike an opt-in procedure, it has a positive effect as regards the problem of rational disinterest. Since participation is anticipated to be greater, higher cost-savings and a better distribution of risk can be achieved. This is especially true in the case of dispersed harms of low individual value, because withdrawal by affected parties in order to bring individual lawsuits is less likely in this scenario.[70] Since an opt-out mechanism is associated with a substantial rise in lawsuits and sanctions, the deterrent effect should also be greater.[71] Furthermore, free-rider behaviour by plaintiffs is made more difficult because free-riders now have to take the initiative and opt out of the class action lawsuit.

If the affected class member does not opt out of the class action, on the one hand he must bear a share of the costs of the lawsuit but in return, he also has a higher probability of receiving a share of the damages payout. An opt-out will depend on the affected party's expectations from an individual lawsuit. That is unlikely to be realistic, if the individual damages are too low to make it worthwhile to bring an individual lawsuit. A different view may be taken, however, if the affected party has suffered more severe damages. An opt-out then seems more plausible. A problematic issue is that opt-outs for precisely this reason can have a negative influence on the remaining group and on the deterrent effect of the class action lawsuit.[72] The obligatory involvement of all affected parties in the proceeding

[67] Van den Bergh and Keske, p. 24.

[68] Van den Bergh and Keske, p. 24.

[69] Cf. Eisenberg and Miller, p. 1 et seqq.

[70] Van den Bergh and Keske, p. 25.

[71] Renda et al., Making antitrust damages actions more effective in the EU; welfare impact and potential scenarios, Report for the European Commission, 2008, <http://www.ec.europa.eu/comm/competition/antitrust/actionsdamages/files_white_paper/impact_study.pdf> (viewed 14 September 2010).

[72] Van den Bergh and Keske, p. 25.

(a mandatory class action) prevents these problems. In terms of efficiency, this option has clear advantages over the other models. The problem remains, however, that it is irreconcilable with certain legal principles.[73]

10.5.4 Problem Areas

Sweetheart Settlements

Opponents of the class action lawsuit warn about a "sell-out" of the class by the class representative (lead plaintiff). The defendant and the group lawyer, it is feared, have a joint incentive to reach a settlement that promises the group lawyer a generous fee and at the same time allocates the class members less than they are entitled to, based on the value of their claims. Sweetheart settlements result from a conflict of interest between the group lawyer and the group he represents. The danger of such a sweetheart agreement is aggravated by the fact that courts are often ill-equipped to uncover them. The judge has limited information and therefore finds it difficult to estimate the value of the claims and to verify whether the amount of compensation is adequate.[74]

It is questionable what influence the form of lawyer remuneration has on this risk. Hourly fee arrangements are likely to reduce the interest in maximising the amount of damages, except for reputational considerations. A possible result of this might be that the lawyer does not exert himself sufficiently to enforce his client's rights. A lawyer working for a contingency fee, on the other hand, will have a greater incentive to devote sufficient time and effort to his brief. It can also be assumed that he will directly reject cases that seem not to be sufficiently well founded.[75]

From the relevant literature, some disagreement is evident on whether contingency fees further exacerbate the risk of sweetheart deals. Contingency fees, the argument goes, lead to earlier settlements and lower settlement amounts.[76] Since the lawyer only receives a percentage of the value at issue, the lawyer's interest never exactly corresponds to the client's interest. The risk of conspiracy could therefore be increased by contingency fees. Other authors take the view that contingency fees set only weak incentives for lawyers to settle, and therefore that the risk of sweetheart deals is also lower.[77]

[73] Van den Bergh and Keske, p. 26.

[74] Hay and Rosenberg, p. 1390.

[75] Van den Bergh and Keske, p. 29.

[76] Schäfer, pp. 192 et seq.

[77] Bebchuck and Guzman, p. 53 quoted after Van den Bergh and Keske, p. 30.

Frivolous Claims and Blackmail Settlements

A fear often associated with the class action lawsuit is that of frivolous or extortionate claims.[78] Such claims give rise to the risk that the defendant is coerced into a settlement on excessively generous terms, even if the claims of the individual group members are founded on a weak basis.[79] If a class action lawsuit is authorised in certain case, going to court can become a very risky enterprise for the defendant. In the USA this problem is further intensified by the jury system. Since the ruling, based solely on the jury's decision, takes the form of an all-or-nothing judgement, the decision can often be likened to the toss of a coin. If the defendant is risk-averse, therefore, even if he has good chances of winning, he will be prepared to enter into a generous settlement so as to avoid court proceedings. The fear is that to force a solid settlement, the plaintiff need do no more than threaten a class action, even if his claims are weak. The amount of compensation in these cases does not correspond to the value of the claims but reflects the defendant's fear of staking everything on one card.[80]

If the claims of the affected parties are brought separately, on the other hand, the defendant is not exposed to this risk. In separate lawsuits, the outcome in court only determines the defendant's liability towards the individual plaintiff whose case is the subject of the proceedings. The plaintiff cannot therefore threaten the defendant with a single all-or-nothing lawsuit resulting in a liability towards all plaintiffs.[81] Opponents of the class action therefore warn that class action lawsuits expose the defendant to a form of blackmail which cannot happen in the context of separate lawsuits. Apart from the danger of insolvency, the defendant in a class action lawsuit also runs the risk of high lawyers' fees, internal corporate costs or reallocation of resources and, not least, reputational damage.[82]

The blackmailing argument is also raised in the Rhône-Poulenc case which is much discussed in the US literature.[83] The appellate court made an order in favour of a group of plaintiffs which had claimed to have been infected with the HIV virus as a result of the defendant's negligent handling of blood products. The appeal court took the view that the defendants' claims must be very weakly founded, the grounds for its conclusion being that 11 out of 12 separate court proceedings on the same matter – initiated by persons not included in the class – were won by the defendant. There is a danger that the defendant in casu enters into a settlement solely to avoid a class action, despite the obvious lack of substance to the plaintiff's claims. Had the defendant lost in the context of class action proceedings, he would certainly have

[78] Rosenberg and Shavell, p. 3.

[79] Hay and Rosenberg, p. 1392.

[80] Hay and Rosenberg, pp. 1391 et seq.

[81] Hay and Rosenberg, p. 1392.

[82] Van den Bergh and Keske, p. 31.

[83] In re Rohne-Poulenc Rorer, Inc., 51 F.3d 1293, 1299 (7th Cir. 1995).

had to file for bankruptcy. The court explained that it was therefore ordering separate lawsuits, to prevent the plaintiffs from using the threat of a class action lawsuit in order to obtain a wrongful settlement.[84]

10.5.5 Potential Solutions

Tighter Control by Group Members

Sweetheart deals highlight possible conflicts of interest between lawyers and clients. This conflict is closely linked to what is known as the principal-agent problem, which arises out of the conflicting interests of the person bringing the lawsuit (the initiator or agent) and the other affected parties (principals) in whose name he is acting. The principal-agent problem is the result of the limited means of the principal (i.e. of the affected parties) to maintain adequate oversight of the agent (the representative) and to monitor his behaviour. The problems can acquire additional conflict potential in cases in which the lawyer is more of a driving force than the designated plaintiff. The individual plaintiffs in class action lawsuits are not directly interested in the case in the same measure as they would be if they were bringing individual lawsuits. Hence the agent has little motivation to devote resources to monitoring the lawyer. This effect can be clearly observed in cases of dispersed harm, where individuals have relatively little personal interest in winning the case.[85] One possible means of counteracting this is to re-establish control of the lawyer by the principals. In part, this means involving all the registered parties on the plaintiff side in negotiating the lawyer's remuneration.[86] An example of such approaches can already be found in the US Private Securities Litigation Act 1995 (PSLRA). According to the Securities Exchange Act (SEA) the lead plaintiff must be in a position not only to oversee the trial appropriately but also to monitor the activities of the lawyer. The courts determine whether this criterion is met. A similar solution is found in the German Capital Investors' Model Proceedings Act for the selection of the model plaintiff.[87]

Equally, the affected third parties' rights to be consulted could be broadened, and they could be authorised to select and dismiss the lawyer. Another conceivable option is to stipulate that common decisions on the most important matters have to be taken by all affected third parties, and that such individuals retain a right to opt out of the class action lawsuit at any time (i.e. in all phases of the proceedings).[88]

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[84] Cf. also Hay and Rosenberg, pp. 1391 et seq.

[85] Van den Bergh and Keske, p. 28.

[86] Van den Bergh and Keske, p. 32.

[87] Cf. § 8 KapMuG (2007).

[88] Hirschman.

Judicial Scrutiny

A further approach to reduce the probability of inadequate settlements (e.g. through legal blackmailing) is that of strengthening judicial scrutiny. Here it is necessary to distinguish between the possibility of a preliminary examination ex ante or a judicial review ex post. A preliminary examination to assess the basis of the case can be helpful to eliminate frivolous and extortionate claims.[89] Such a step was also introduced in the PSLRA. However, there is a danger that legitimate claims may also be deterred.[90] On the other hand, judicial scrutiny ex post could be beneficial in order to prevent inefficient settlements. Courts could thus monitor and approve offers of settlement (as provided for under the US Class Action Fairness Act). Moreover, consideration could be given to applying judicial control to fee arrangements with the lawyers.[91] But judicial scrutiny comes at a price, as it entails higher procedural costs. In any case, the effectiveness of such control is questionable. Courts are not always in possession of the necessary information to assess settlements.[92]

Auctions

The possibility of conducting auctions is often discussed in relation to class action lawsuits. Different forms of auctions are conceivable. One possibility would be the auctioning of the claim itself. The protected rights would go to the party who outbid all other competitors. It would remain to be determined who is entitled to participate in such an auction. Another possibility would be to auction the brief to represent the plaintiff group. In the USA this procedure is already a reality. Lawyers submit sealed bids, stating the size and composition of the fee they require. Contingency-fee arrangements that secure the lawyer a percentage rate, contingent upon the amount of damages claimed, reduce the risk of premature settlements. Therefore these are preferred over contingency-fee arrangements with constant percentages. A problematic aspect, however, is that existing information deficits make it enormously difficult to determine the amount at issue. Thus, it is also conceivable that the auction could be won by a low bidder who turns out not to be capable of providing the plaintiff group with the best possible representation.[93]

[89] Van den Bergh and Keske, p. 33.

[90] Choi, p. 1465.

[91] Resnik, p. 835.

[92] Van den Bergh and Keske, p. 33.

[93] Van den Bergh and Keske, p. 34.

10.6 Conclusion

The last decade has seen a turnaround in procedural law trends within Europe for tackling mass and dispersed harms. Class action lawsuits are no longer an exception "made in the USA", but are already an element of several European legal systems. Nevertheless, class actions in Europe remain controversial. Consequently, other alternative means of collective legal protection (particularly model proceedings and lawsuits brought by associations) are being piloted alongside class action lawsuits. The common aim of these different attempted solutions is to reap the benefits of grouped interests whilst avoiding "American conditions". This may well succeed, since a combination of punitive damages, contingency fees and disclosure, all familiar elements of the US class action system, do not exist in the same form in European jurisdictions; particular elements of the toxic cocktail are either unknown or are more restrictive in structure. The difficulty of attempting to import only the benefits of the class action is seen particularly with regard to the question of whether to implement the opt-in or the opt-out system.[94]

An economic analysis of law has weighed up opt-in and opt-out procedures and shown the latter to be more effective with regard to the deterrent effect. They also deal better with the problem of rational disinterest. Presumably the potential perpetrator of harm assesses the probability of a sanction to be higher, heightening the deterrent effect accordingly. Group lawsuits without the possibility of an opt-out fare even better in this regard. Affected third parties need not give an opt-in declaration, nor can they opt out of the class action lawsuit. Potential perpetrators of harm must therefore expect the amount of damages to correspond to the total cost of the harms caused. Equally, they are an effective instrument for minimising rational disinterest.[95] However, they contravene the principle that the individual claimant should decide whether or not his claim should be litigated at all. For this reason, the majority of adaptations of the class action system in Europe are geared towards the opt-in system. Concerning arrangements such as lawyers' fees or the cost-allocation rule, elements of US law that are rejected in Europe could be significant for the effectiveness of collective legal protection. Thus, European legal traditions such as the English rule, for example, should sometimes be critically questioned in order to enable an effective class action lawsuit.

Time will tell whether the European versions of the class action lawsuit offer the right solutions or whether, as feared, they cause legal culture to deteriorate. The development of collective legal protection in Europe is still in a state of flux and merits continuing close attention. Economic analysis of law can add an important dimension to the debate, and should undoubtedly be integrated into the discourse.

[94] Cf. Droese, pp. 132 et seq.

[95] Van den Bergh and Keske, p. 40.

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Chapter 11
Crown Witnesses in Switzerland?

The Crown Witness in the Dialectical Tension Between Security and Rule of Law

Zinon Koumbarakis

Abstract Crown-witness provisions create numerous problems and tensions on different levels of the Swiss legal system, which are not only multilayered but also interconnected and of varying importance. In contrast to the United States or Germany, for instance, relatively few essays on this subject have been published in Switzerland.[1] However, the findings from other countries must not be transferred to Switzerland without further analysis because the framework conditions and needs for use are often fundamentally different. But even in Switzerland, the central dialectical tension between security and rule-of-law considerations can be resolved.

11.1 Introduction

As in other jurisdictions, (criminal) justice in Switzerland is confronted with cases which defy traditional investigative and procedural strategies. This realisation has prompted the legislator to take numerous steps since the end of the 1980s, particularly to combat organised crime. Due to the increasingly impervious nature of criminal entities, for some time the authorities have resorted to diverse methods of evidence gathering such as covert investigation and the monitoring of postal and telephone traffic in order to obtain information from the criminal milieu. A further

[1] Cf. Koumbarakis, N 1 et seqq.

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means of obtaining evidence brings us to the institution of the witness who gives evidence for the state, referred to here as the "crown witness" (*Kronzeuge*).

Due to the growing complexity of cases to be investigated and the escalating pitch of the global struggle against organised crime and terrorism, the concept of the crown witness is garnering ever greater interest, including in Switzerland.

11.2 Object of a Crown Witness Provision

In the following, a crown witness provision is understood to be a model which has certain characteristic *features*: its central element is not a legal concept but a shorthand formula for a particular question to be addressed by crime policy.[2] Characteristically, a crown witness provision in this sense has four features:[3]

- The crown witness's crime,
- Assistance with the investigation,
- Privilege accorded to the crown witness, and
- Interdependency of these elements.

A crown witness can be any person against whom there is at least reasonable suspicion of having committed some criminal act (the crown witness's crime, or in German, the *Kronzeugentat*[4]).

The crown witness cooperates with the prosecuting authorities by revealing certain information. This information relates to a crime under investigation (in German, the *Aufklärungstat*). Unlike cooperation from an offender who merely confesses, the crown witness's cooperation goes further and is not confined exclusively to the criminal procedure directed against himself. He helps with the detection and prosecution of crimes committed by third parties, although these are frequently fellow offenders or other co-conspirators.[5] Investigative assistance amounts to disclosures aimed at enabling the authorities to arrest offenders, solve crimes or prevent specific crimes from being committed. Thus a crown witness provision, depending on the concrete terms of codification, can pursue repressive and/or preventive objectives. The criteria regarding the extent of these disclosures can also vary.

The crown witness is rewarded for this investigative assistance with benefits that have some bearing on the crown witness's crime. These benefits are referred to as the crown witness's privilege (*Kronzeugenprivileg*). Many different ways are conceivable in which a crown witness can be rewarded for investigative assistance; for instance, non-prosecution, immunity from punishment, reduced sentencing, or the granting of advantages within the penal system (an open prison, early release on parole, etc.).

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[2]Likewise Bernsmann, p. 539; Jaeger, p. 2; Jung, p. 39 fn. 113; to the point, Wiesner, p. 7.

[3]Cf. in detail Koumbarakis, N 48 et seqq.

[4]Cf. also terminology in Bocker, p. 10; Jaeger, pp. 3 et seq.; Jessberger, p. 30; Gropp, p. 459.

[5]Denny, p. 270; Jessberger, p. 27; Mehrens, p. 19.

Finally, every crown witness provision is characterised by a *dependency* between the crown witness's willingness to provide investigative assistance, and the crown witness's privilege. Both features are in a relationship of reciprocity, like the service rendered and consideration collected in a contractual exchange ("synallagma").[6]

11.3 Investigative Necessity

The crown witness's assistance with the investigation is accentuated in cases of so-called investigative necessity (*Ermittlungsnotstand*). The essence of such an investigative necessity is a deficit in the investigation coupled with pressure of criminality.[7]

The prerequisite for an investigative deficit is that attempts by the state to penetrate the criminal milieu – if criminal behaviour is even detected – prove unsuccessful without the use of crown witnesses.[8] There are various reasons for this: in the domain of general crime, in the overwhelming majority of cases a criminal prosecution is prompted by a private report drawing attention to a crime. A penal procedure is triggered in nine cases out of ten by a citizen's report to the police,[9] although the rate varies by type of crime. Reports by the putative victim are the most common by far.[10] Difficulties arise in the absence of this source of information, at least with regard to substantiating the initial suspicion. This is a particular problem in what are known as "victimless" crimes; for example, crimes against the community or in relation to the supply of black markets (as in the case of drug or arms dealing).[11] Deficits in investigation can also arise if victims willing to report crimes live in fear of reprisals, which may apply to the victims of a human trafficking ring, for example.[12] Unwillingness to report crime or cooperate with an investigation can further be ascribed to the criminal implication of the persons concerned themselves. Finally, the main cause of a deficit in the investigation of crime, and particularly organised crime, is a particular element of conspiracy or secrecy. Especially a cumulation of the said circumstances can result in a deficit in the investigation of crime for the prosecuting authorities.[13] An investigative deficit is often a permanent state of affairs in relation to highly organised and complex forms of offence. The term investigative necessity (or investigative emergency, *Ermittlungsnotstand*) underscores the principle that crown witnesses should not be employed to overcome any and every deficit in

[6] Koumbarakis, N 52.

[7] Koumbarakis, N 79 et seqq.

[8] Cf. Jessberger, pp. 103 et seq.

[9] According to the comparable figures in Germany, cf. Eisenberg, § 26 N 19; Kerner, p. 24.

[10] Eisenberg, § 26 N 19.

[11] Schweizerischer Bundesrat, *Botschaft 1998 II*, p. 4245; Stegmann, pp. 127 and 146.

[12] See Bundesamt für Justiz, *Bericht Menschenhandel 2001*, pp. 47 et seqq.

[13] See Donatsch, 'Anonymität', p. 400; Stegmann, p. 8 point 3, pp. 128 and 146.

investigation, but only in "situations of necessity".[14] Thus, the investigative efforts of the prosecuting authorities must not merely have run into difficulties due to the scale or complexity of the case, but must also have proved largely unsuccessful.[15] Thus the existence of an *insuperable obstacle to investigation* becomes a central characteristic of an investigative necessity.

An investigative deficit alone is not sufficient grounds for assuming an investigative necessity, since the use of a crown witness provision to clear up all unsolvable offences gives rise to so many constitutional and criminal-procedure misgivings as to render it virtually unjustifiable. A further prerequisite for the assumption of an investigative necessity should therefore be that the *pressure of criminality has become intolerable*.[16] This may be true in the case of especially serious crimes such as murders or human trafficking but not of trivial offences such as minor drug offences. This aspect is an important one, otherwise criminal justice would undermine itself.[17]

11.4 Crown Witness Provisions in Swiss Law

11.4.1 In Criminal Law: Article 260ter Paragraph 2 of the Swiss Criminal Code

The scope of application of Article 260ter paragraph 2 of the Swiss Criminal Code (StGB)[18] is limited to punishable acts in connection with criminal organisations pursuant to Article 260ter para. 1 StGB. According to Art. 260ter para. 2 StGB the court has discretion to mitigate the penalty if the offender makes an effort to thwart the criminal organisation's further criminal activity.[19]

Hence, a key reference point of this definition is the term "criminal organisation", only the basic features of which will be elucidated here. An *organisation* within the meaning of Art. 260ter para. 2 StGB is a grouping of persons characterised by various traits, which are non-cumulative criteria: a permanent group structure, strict division of labour, profit motive, strict hierarchy, inward and outward imperviousness, enforcement mechanisms for internal group norms, willingness to defend and expand on its position, willingness to commit acts of violence and to gain influence over politics and business, and professionalism and substitutability of members.[20] The final criterion sets it apart from the gang, which is geared towards

[14] Cf. along these lines Jung, pp. 66 et seq.

[15] Cf. Jessberger, p. 104.

[16] Cf. Jaeger, pp. 6 et seqq., p. 41; Jessberger, p. 103; Jung, p. 66; Lammer, p. 250.

[17] Koumbarakis, N 82.

[18] Schweizerisches Strafgesetzbuch (Swiss Criminal Code) of 21 December 1937, SR 311.0.

[19] Koumbarakis, N 92 et seqq.

[20] Baumgartner, 'BSK StGB II, Art. 260ter', N 6.

the cooperation of very specific persons. An organisation is *criminal* if its structure and composition are kept secret (although general discretion in the committing of crimes is not sufficient) and an essentially criminal purpose is pursued (crimes of violence or enrichment).[21] Article 260ter StGB thereby covers both terrorist groupings and groups that seek to secure economic benefits through crime.[22] The existence of a criminal organisation in the said sense is not assumed lightly in Switzerland, since it presupposes an objectively extraordinary level of risk.

The concept of organised crime has to be distinguished from that of the criminal organisation. The activities of a criminal organisation can generally be classified as organised crime, but not always vice versa. To that extent no fields of activity can be ascribed to the criminal organisation that differentiate it from other organised crime.[23]

The criminal policy objective of Art. 260ter para. 2 StGB consists of supporting the prosecuting authorities in combating criminal organisations. The offender willing to cooperate can be rewarded for his commitment with mitigation of his sentence.[24] This incentive is aimed at activating the offender's willingness to assist in defending against the risks that such organisations typically pose. In this regard, the use of insider knowledge takes on central significance. Art. 260ter para. 2 StGB presupposes an "effort" to prevent further criminal activity of the criminal organisation.[25] What this means from case to case is left to the court's discretion, as is the decision on what scale of mitigation it chooses to apply to the sentence. It takes into consideration not only actions by the offender intended to directly foil future crimes planned by the organisation, such as warning the envisaged crime victim or sabotaging preparations for the crime, but also passing relevant information to the police aimed at thwarting the crime indirectly, as can occur if members of the organisation are betrayed.[26]

11.4.2 In Administrative Criminal Law: Art. 13 of the Federal Act on Administrative Criminal Law (VStrR)

According to Art. 13 VStrR[27] the offender avoids punishment if he reports, of his own accord, his contravention of a payment or repayment obligation. Furthermore he is required, as far as could reasonably be expected, to have given complete and accurate details on the fundamentals of the payment or repayment obligation, to

[21] Baumgartner, 'BSK StGB II, Art. 260ter', N 7.

[22] BGE 128 II 355 et seqq.; BGE 125 II 574.

[23] Arzt, N 15 et seq.

[24] Baumgartner, 'BSK StGB II, Art. 260ter', N 15.

[25] Baumgartner, 'BSK StGB II, Art. 260ter', N 15.

[26] Cf. Schweizerischer Bundesrat, *Botschaft 1993*, p. 303.

[27] Bundesgesetz über das Verwaltungsstrafrecht (Federal Act on Administrative Criminal Law) of 22 March 1974, SR 313.0.

have contributed to investigating the case, and to have fulfilled any obligation that was incumbent upon him. Finally, he must never have previously have given a similar declaration of a false or incomplete tax return as a result of a deliberate contravention of the same kind.

In administrative law, particularly in tax law, all parties have an interest in self-reports by "remorseful" offenders. The investigation of serious fiscal and economic offences can prove extremely difficult due to their opaque and complex circumstances, since offences are often committed in sophisticated ways with the complicity of numerous co-conspirators.[28] The legislator's intention that the offender should be certain of freedom from punishment in all instances could not be realised, however. Due to various issues relating to the definition of the prerequisites, it is difficult not only for the offender but also for the advising attorney to gain an overview of whether his client will or will not ultimately escape punishment.[29]

11.4.3 In Cartel Law: Art. 49a para. 2 of the Cartels Act (KG)

According to Art. 49a para. 2 KG[30] the Swiss Competition Commission can dispense wholly or partially with direct sanctions against an enterprise which, as a cartel member, has cooperated in uncovering and overturning the cartel in question. This crown witness provision in Art. 49a para. 2 KG is not to be confused with the reporting right (*Melderecht*) according to Art. 49a para. 3 KG. The latter is intended for enterprises which are not clear about the permissibility of a particular behaviour under cartel law, before its effect is known, and is intended to increase legal certainty for the enterprises concerned.[31]

The waiving or reduction of sanctions is not the objective of the crown witness provision, but a means to that end. Primarily, the crown witness provision under cartel law aims to create a denunciation incentive for cartel members inclined to quit the cartel, which enables cartels to be uncovered and competition to be restored. The waiving of sanctions is intended to increase the chances of cooperation since cartel members willing to testify will balance the advantages of cooperation against the disadvantages. In this process, the possibility that sanctions will be waived carries positive weight. Tougher sanctions and crown witness provisions also have an ambivalent character.[32] Moreover, the denunciation incentive is aimed at heightening mistrust and hence at causing destabilisation within the cartel. The crown witness provision is aimed at weakening the mutual loyalty and solidarity of

[28] Schweizerischer Bundesrat, *Botschaft 1971*, p. 1001.

[29] Koumbarakis, N 125 et seqq.

[30] Bundesgesetz über Kartelle und andere Wettbewerbsbeschränkungen (Federal Act on Cartels and Other Restraints on Competition) of 6 October 1995, Kartellgesetz (Cartels Act), SR 251.

[31] Koumbarakis, N 112 et seqq.

[32] Schweizerischer Bundesrat, *Botschaft 2001*, p. 2038; Scheidegger, p. 7.

cartel members, which may even lead to a kind of "competition for the cooperation bonus". Weakening the structure and stability of cartels is also seen as a preventive contribution.[33] Art. 49a para. 2 KG is aimed at facilitating the investigation of the case by the Competition Commission, since the information comes directly from insiders and there is thus a possibility that cartels will be uncovered which would otherwise go undetected. Particularly in establishing the initial suspicion, a crown witness provision can be of decisive importance in order to break through the "wall of silence".[34] Experience gained abroad with crown witness provisions under cartel law carries positive weight. Yet caution is advised, since comparisons of individual points can lead to false conclusions unless the context of a regulation is also taken into consideration.

11.5 The Crown Witness in Light of the "Prisoners' Dilemma" Situation

The incentive for cooperation can be influenced by placing crown witnesses in a relationship of competition. To justify a crown witness provision in cartel law, as mentioned it has been argued without further substantiation by legislator and doctrine that a crown witness provision might lead to a kind of "competition for the cooperation bonus". How can this effect, which might also be transferable to criminal law, be substantiated?

The answer is linked to "interest-based" approaches to legal theory,[35] the objective of which is to explain and justify fundamental norms and institutions on the basis of the individual's rational self-interest.[36] Central to this approach is the concept of the *prisoners' dilemma* situation, which originates from game theory.

In economics, the prisoner's dilemma refers to a particular analysis of interpersonal decision-making situations. The starting point is the idea that the protagonists are enmeshed in a network of mutual relationships so that the outcomes of their action depend on the behaviour of opponents.[37] What is meant by the prisoners' dilemma is an incentive structure which will either inhibit or at least jeopardize collusion between crown witnesses even though it would be advantageous from their viewpoint. Such a situation is caused by the fact that every crown witness is subject to the temptation to improve his own position at the other's expense.[38] The underlying incentive structure can best be explained with an example:

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[33] Schweizerischer Bundesrat, *Botschaft 2001*, p. 2038; Hettich and Winkler, p. 682; Krauskopf and Senn, pp. 15 et seq.; Scheidegger, pp. 7 et seq.

[34] Dähler, p. 5; Hettich and Winkler, p. 682; Müller-Tautphaeus, p. 208; Wiesner, pp. 57 et seq.

[35] Cf. Koumbarakis, N 140 et seq.

[36] Engländer, p. 536 with further references.

[37] Helmedag, p. 1494.

[38] There are numerous papers discussing the prisoners' dilemma (especially in the field of social psychology), cf. inter alia Ricks, p. 35 fn. 57 with further references.

Two prisoners (A and B) accused of a crime are held in detention before the case goes to trial. Since the public prosecutor's evidence is relatively poor and only likely to convict the prisoners of a considerably less serious crime unless they confess, the prosecutor attempts to recruit them both as crown witnesses. At this point the prisoners are questioned separately, and given no opportunity to collude either before or during questioning.

The separate detention of crown witnesses is not always viewed as a necessity; for instance, a night in a shared cell before interrogation might be deemed insufficient to permit them to reach a reliable agreement. Although both prisoners may promise to deny the crime, when it comes to the moment of truth, confession remains the dominant strategy for each of them.[39] Despite this objection, in practice crown witnesses should be separated so as not to jeopardise the effect of the prisoners' dilemma.

The prisoners are faced with the following prospects: if both deny the crime they only receive a short sentence for the minor offence, amounting to 1 year's imprisonment each. If only one confesses, he enjoys immunity from punishment as the crown witness while the other is condemned to the maximum sentence of 20 years. If both confess, these confessions are taken into consideration and mitigate the sentence, but the prisoners are nevertheless sentenced to 15 years each.[40] The figures in the following chart[41] show the evaluation of the situation for prisoners A and B.

Prisoner A (Prisoner B)	Denial	Confession
Denial	1 year/(1 year)	20 years(0 years)
Confession	0 years(20 years)	15 years(15 years)

From the point of view of an observer, it would obviously be utility-maximising for *both* prisoners to choose denial, since they would then only face a 1-year sentence. The dilemma is that for the *individual* prisoner from *his* own viewpoint, it is always utility-maximising to act independently of the other prisoner's behaviour. If B opts for denial it is rational for A to confess, since prisoner A then escapes punishment. If B confesses it is also rational for A to confess, since otherwise A would be sentenced to the maximum sentence of 20 years. The same applies from the perspective of B. Whilst no definitive choice of action can be stipulated, the most probable outcome is that both will confess in order to minimise the risk of a maximum sentence. The risk of a maximum 20-year sentence is ruled out since both offenders are sentenced to 15 years imprisonment.[42]

[39] Helmedag, p. 1496; cf. also Ricks, pp. 35 et seq.

[40] Engländer, p. 538; Helmedag, p. 1494; cf. also Gneuss, p. 81; Ricks, p. 35 fn. 57.

[41] From Koumbarakis, N 140.

[42] Engländer, p. 538; Helmedag, pp. 1494 et seq.; cf. also Ricks, pp. 35 et seq.

The prisoners' dilemma does not revolve merely around the question of the direct consequences of a crown witness's decision. The interdependencies with the action of the other crown witnesses must also always be taken into consideration. In this context, mention is made of the Nash equilibrium within the prisoner's dilemma, as expressed by the mathematician John F. Nash in 1950. The discussion hitherto has only referred to two crown witnesses. As the numbers rise, there is rising uncertainty about the behaviour of other players, which also increases the probability of cooperation with the prosecuting authorities. Crown witness provisions can thus lead to competition for the cooperation bonus based on the rational self-interest of each crown witness, provided that at least two crown witnesses are involved. What this means is that prosecuting authorities should attempt to interrogate at least two crown witnesses. The competition for crown witness's privilege can be intensified if each offender strives to assist the investigation at an earlier point in time than the others. Crown witnesses may attempt to provide the public prosecutor's department with (as yet) unknown information in order to gain greater advantages in relation to the crown witness's crime.[43]

Although the prisoners' dilemma has a positive effect from the perspective of the prosecuting authorities, it can also have adverse consequences. The prisoners' dilemma effectively maximises the length of the sentence to be served, with the result that accused parties without an alibi might confess to acts they did not commit.[44] A further consequence of the prisoners' dilemma can be the implication of innocent third parties by crown witnesses, in order to demonstrate the degree of cooperation expected by the prosecuting authorities.

Since numerous other factors affect the decision-making of crown witnesses in reality, their behaviour cannot always be predicted conclusively in advance. In volatile circumstances in which decision-makers are expected to make quick and pragmatic decisions, however, the prisoners' dilemma can certainly provide a heuristic approach. This is confirmed by reports from German practice, according to which crown witness provisions are applied most effectively in conjunction with coercive procedural measures, namely after a period of pre-trial detention. In contrast, cooperativeness was found to be particularly low in the context of interrogation of a suspect after a normal summons.[45] Finally, organised crime will try to inhibit the effect of the prisoners' dilemma by ensuring the behavioural consistency of crown witnesses.[46]

[43] Cf. Denny, p. 277; Volk, p. 881.

[44] Helmedag, p. 1496.

[45] Jessberger, p. 123 fn. 175 with further references.

[46] Koumbarakis, N 140 et seq.

11.6 The Crown Witness Agreement

11.6.1 Background and Legal Position

Plea agreements are mostly based on a confession in exchange for leniency with regard to sentencing.[47] In the case of crown witness agreements, the main priority is not the confession but rather the wider-ranging investigative assistance. Therefore the magnitude of the crown witness's act is greater than that of the offender who has merely confessed.[48] In the absence of a crown witness provision, the reward for the crown witness's investigative assistance ought to remain within the confines of what is otherwise generally permitted. In that respect, crown witness's privilege is a specifically codified legal basis for rewarding the crown witness, whereas leniency from the prosecuting authorities in general does not represent a specific legal basis.[49] The justification for the crown witness's privilege is the elimination of a deficit in information, whereas arguments put forward in favour of plea agreements mainly invoke procedural economy.[50]

Plea agreements, in the sense of deals between the prosecuting authorities and the accused within the penal process, are barely reconcilable with the Swiss law of criminal procedure.[51] For instance the Swiss Federal Supreme Court states: "In the Swiss criminal process it is fundamentally impermissible to induce the accused to confess by promising immunity from punishment or a more lenient sentence. In any case, such procedural agreements between criminal justice and the accused (in the sense of true 'plea bargaining' or a 'guilty plea' on the model of Anglo-American law) are alien to the law of Swiss criminal procedure *de lege lata*."[52] Numerous authorities on doctrine also take a sceptical stance on "plea bargaining" or similar institutions.[53]

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[47] Janke, p. 49; Oberholzer, 'Absprachen', p. 159; cf. also BGer-Urteil (Swiss Federal Supreme Court Judgment) 6S.186/2003 of 22 January 2004 E.5.7.2.

[48] Cf. Koumbarakis, N 68 et seqq.

[49] According to Mehrens, p. 41.

[50] Cf. Expertenkommission "Vereinheitlichung des Strafprozessrechts" EJPD, *Aus 29 mach 1*, p. 52; Eidgenössisches Justiz- und Polizeidepartement, *Begleitbericht StPO 2001*, pp. 231 et seq.; Braun, *Absprachen*, p. 7; Donatsch, 'Vereinbarungen', p. 161; Oberholzer, 'Absprachen', pp. 160 et seq.

[51] Cf. Koumbarakis, N 73 et seqq.

[52] BGer-Urteil (Swiss Federal Supreme Court Judgment) 6S.186/2003 of 22 January 2004 E.5.7.1.; Pieth, p. 159.

[53] Expertenkommission "Vereinheitlichung des Strafprozessrechts" EJPD, *Aus 29 mach 1*, pp. 51 et seq.; Eidgenössisches Justiz- und Polizeidepartement, *Begleitbericht StPO 2001*, p. 231; Braun, 'Das abgekürzte Verfahren, p. 149; Brunner, p. 27; Donatsch, 'Vereinbarungen', p. 176; Hauser, Schweri and Hartmann, § 49 N 5; Vest, p. 302 fn. 33.

One statutory provision for a type of procedure that comes *very close to plea agreements* is the so-called "abbreviated procedure" (*abgekürztes Verfahren*) set out in Articles 365–369 StPO.[54] Two conditions have to be met cumulatively for an abbreviated procedure to be conducted. The accused must have acknowledged the essential elements of the case to be adjudicated, which equates to a confession. Furthermore they must have acknowledged civil claims, at least in principle. The abbreviated procedure can be applied up until the indictment is brought. The stipulated sentence may not exceed 5 years' imprisonment. If the parties agree, the public prosecutor's department forwards the bill of indictment together with the files to the court of first instance for the conduct of the main proceedings. During these court proceedings there is *no* evidence-taking procedure. The court satisfies itself as to whether the abbreviated procedure is lawful and appropriate (lit. a), the indictment is compatible with the outcome of the main proceedings and with the files (lit. b), and the requested sanctions are appropriate (lit. c). If these preconditions are met, the indictment is passed up for judgement regarding the elements of the offence, the sanctions and the civil claims. Admittedly the Swiss Code of Criminal Procedure makes no explicit provision for the possibility of plea agreements. It appears indisputable, however, that the abbreviated procedure creates the statutory basis for plea agreements between the prosecuting authorities and the accused. The detailed contents of plea bargains agreed under the abbreviated procedure vary greatly, and may theoretically go as far as a crown-witness immunity agreement.[55]

11.6.2 De Facto Ingress Points for Plea Agreements

The Swiss law of criminal procedure has some existing ingress points for plea agreements. These ingress points could also be utilised to reward crown witnesses. In the following, the areas of greatest potential for such utilisation will be shown without conveying any false impression that these ingress points might currently be used in practice. In general, the main phase in which plea agreements might be used is during the *investigation and inquiry procedure* born of the investigative authorities' remit to thoroughly establish the facts and the legalities of the case. Discretion is exercised by the public prosecutor's office, largely without any legal control apart from the official supervision of the chief prosecutor's office. Furthermore, the preliminary procedure is secret as a matter of principle, with the result that agreements can be reached with great confidentiality.[56]

A de facto ingress point of significance is the *principle of opportunity*. Emerging from practice on the principle of opportunity, particularly the de facto principle of

[54] Koumbarakis, N 74.

[55] Donatsch, 'Strafprozessrecht', p. 327.

[56] Cf. Koumbarakis, N 76 et seqq.

opportunity, the phenomenon of plea agreements has crept in.[57] One possible guise would be the claim of a lack of evidence, leading the investigative authorities to drop a case.[58] In very general terms, there would then be a risk of substantially influencing the sentence even without any judicial involvement in a plea agreement, since the court is presented with the essential foundations of the decision in the sense of the agreement. For crown-witness agreements the de facto ingress points mean that contrary to current law a crown witness could be rewarded by – for example – granting a (partial) stay of prosecution, limiting the substance of the indictment, or claiming a lack of evidence for the crime of which he is accused. All these points are directed primarily at the restricting the scope of the case at issue.

From practice it is known that the "principle of opportunity" acquires particular significance in *narcotics and economic crimes.* In economic criminal cases, for instance, it is alleged that elements of the investigation are deemed off limits, ended with or without a formal stay of proceedings, or simply not tackled. The leniency of the investigating officials in not scrutinizing certain areas of business (e.g. tax fraud, bankruptcy and documentation offences) is made dependent on the cooperation of the accused. In this regard the defending lawyer must "exhibit sufficient sensitivity to negotiate such not-openly-articulated deals . . . [. . .] with the client and to incorporate them into the defence strategy".[59] Very generally it is argued, the need for informal settlement becomes relevant particularly where the legal position and/or the evidence is unclear, and where there is a risk of prolonged hearing of evidence.[60] To that extent there is a need for informal settlement in connection with crown witnesses, too, since the elimination of substantial difficulties of proof is the aim of any crown witness provision. Further scope for agreements is also provided by the option of summary proceedings without trial (355 et seqq. StPO).

11.7 The Dialectical Tension: For and Against a Crown Witness Provision

In light of the most important arguments for and against a crown witness provision in Swiss law, what emerges most clearly is the dialectical tension between security, on the one hand, and misgivings about the rule of law, on the other.[61]

[57] Oberholzer, *Strafprozessrecht*, N 713; Morscher, p. 182 et seq.; cf. also Vest, p. 300 fn. 26.

[58] Braun, 'Das abgekürzte Verfahren, p. 149; Oberholzer, 'Informelle Absprachen', pp. 9 et seqq.; Schlauri, p. 483; Sollberger, p. 58.

[59] Baumgartner, 'Strafverteidigung', pp. 317 et seq. (own translation).

[60] According to Oberholzer, *Strafprozessrecht*, N 713.

[61] Cf. Koumbarakis, N 351 et seqq.

11.7.1 Arguments in Favour of a Crown Witness Provision

Investigative necessity: The principal argument in favour of a crown witness provision is to overcome investigative difficulties experienced by the prosecuting authorities. In certain areas of crime, as already shown, the existing set of instruments available to the prosecuting authorities can fail. Crown witness provisions are fundamentally appropriate means of addressing a true investigative necessity. Especially in relation to serious crimes, information about the offence leading to the offender's arrest or prevention of the offence are of great significance. In such cases criminal justice comes under huge pressure to bring a successful prosecution. With the help of crown witnesses, it may then be possible to restore public confidence in the functioning of criminal justice.

Efficient use of available resources: Crown witness provisions can lead to more efficient use of the resources available to the prosecuting authorities. The crown witness's investigative assistance may prove to be a gateway for evidence, allowing a more targeted use of existing resources. This effect is intensified if there are several crown witnesses who end up competing for the crown witness's privilege. Experience with crown witness provisions in Germany and Italy has shown that beyond the area of minor and moderate crime, these can be (but are not guaranteed to be) successful.

Destabilisation effect: Crown witness provisions heighten mistrust within criminal organisations, introducing an element of insecurity into the criminal environment.

Offender's perspective: Crown witness provisions can be an incentive for an offender to turn away from crime and lead a law-abiding life. The incentive depends upon the detailed form of the crown witness provision and upon flanking measures (particularly witness protection measures).

Cost argument: Crown witness provisions are essentially cost-neutral and, in times of scarce financial resources, an attractive means of fighting crime. Any flanking measures can give rise to considerable costs, however.

Legal reality: Even in the absence of a crown witness provision, there is a risk that crown witnesses will be used mainly at the pre-trial stage. For instance, in narcotics crime it is alleged that the police rewarded informers not only financially but with non-prosecution. Possible references to crown witnesses in the Swiss legal reality can also be found in the daily press. For example, in the case of the Zurich Kongresshaus heist, the defence attorney for the driver and lookout who received an early, lenient sentence stated that his "client was a crown witness. Only his confession and his cooperation had made it possible to clear up the crime."[62] In a

[62]Neue Zürcher Zeitung (NZZ) of 12/13 March 2005, p. 51 ("Aus dem Bezirksgericht Zürich: Erstes Urteil im Kongresshaus-Coup"); NZZ of 15 December 2005, p. 57 ("Aus dem Bezirksgericht Zürich: Mit Nachschlüssel in die Antiquitätenmesse").

drug smuggling case, the Zurich district court had sentenced a "crown witness" who was substantively involved in importing 122 kg of cocaine to four-and-a-half years imprisonment. The reason for the relatively lenient sentence was that the accused's testimony had helped to break up a major drug-pushing ring.[63]

11.7.2 Arguments Against a Crown Witness Provision

Misgivings about the rule of law: The principal argument against a crown witness provision is that it raises misgivings about the rule of law. It collides with the essence of the legality principle of criminal procedure as well as the principle of culpability. Certain problems also arise with regard to the principles of legal equality, the public dispensation of justice and the presumption of innocence. Furthermore, a crown witness provision increases the risk of plea agreements.

Effectiveness: The effectiveness of a crown witness provision depends on the nature of the offenders targeted. In contrast to offenders motivated by self-interest, it appears less well-suited to ideologically motivated offenders. Furthermore, the credibility of the testimony given by crown witnesses can be viewed as problematic. There is a heightened risk of deception of the court and of miscarriages of justice.

Structure of the criminal procedure: A crown witness provision can shift the procedural balance between the accused and the investigative authorities, and from the main to the investigative procedure. A further risk is that the crown witness could become "master of the proceedings" because of the importance of his role. To a certain extent, moreover, the defence attorney could become an adjunct official to the public prosecutors by advising the client to betray accomplices and cooperate in their arrest and conviction. This argument must be qualified since it is the attorney's task to explain to his client the actual and legal consequences of investigative assistance within the framework of a crown witness provision, without pushing him in any particular direction.

Ideal of justice: Justice, understood as the sum of the principles of criminal law and the law of criminal procedure in a rule-of-law state, for the most part contradicts a crown witness provision; such a provision conflicts with absolute penal theories and the principle of culpability, so that essentially there is often a sense that rewarding the crown witness is unjust. Moreover, it can have a negative influence on willingness to comply with norms, and on trust in the legal order. The latter should be qualified since restoration of the legal order is, in effect, the purpose of a crown witness provision.

[63] NZZ of 3 November 2000, p. 49 ("Aus dem Bezirksgericht Zürich: Milde Strafe für 'Kronzeugen'"); cf. also NZZ of 4 February 2004, p. 55 ("Aus dem Bezirksgericht Zürich: Krankenschwester als Heroin-Transporteurin").

Moral argument: It is perceived as problematic to reconcile a crown witness provision not only with Switzerland's binding values but also with that country's understanding of law and sense of justice. However, moral scales cannot be measured exactly, nor weighted in an objective sense.

Psychological stress on the crown witness: The obligation of testifying as a crown witness can cause serious psychological stress. Because of the mental pressure crown witnesses are under, they are frequently unaware of the risks associated with their testimony.

11.8 Resolving the Dialectical Tension in Swiss Law

The arguments for and against a crown witness provision can be assessed quantitatively or qualitatively. Since arguments should be weighed and not counted, qualitative assessment of the arguments takes priority. The objective is now to resolve the dialectical tension engendered by a crown witness provision. An attempt will be made to find an equilibrium by means of a *balancing test* that correctly weights the significance of the different positions.[64]

The process of balancing interests is a fundamental problem that recurs throughout the penal process. Collective and individual interests, set side by side with parity of value, determine the structure of the penal process. Resolution of the dialectical tension in keeping with rule-of-law principles cannot be biased towards one set of interests or the other.[65] The way in which different interests are delimited is a yardstick for the political and legal culture of a state, for which reason criminal procedure is also referred to as a "seismograph of the state constitution".[66]

This balancing is primarily a task of legislation, in the course of which the many affected interests (reasons for and against, advantages and disadvantages) should be taken into account as far as possible and brought into equilibrium.[67] Moreover, legal adjudication is also affected by the issues surrounding a balancing test. Often it sees the balancing procedure as a way through the "black box" of a non-rationalisable act of evaluation.[68]

There is no particular method of balancing interests.[69] In order to ensure the transparency of the overall balancing test to be conducted here, the circumstances considered important for the purpose of the balancing test were specified. Particular emphasis and weight is attached to the investigative-necessity argument in favour

[64] Cf. Koumbarakis, N 354 et seqq.

[65] Cf. Hauser, Schweri and Hartmann, § 3 N 3; Kunz, p. 37.

[66] So Roxin, § 2 N 1; cf. also Schmid, N 12.

[67] Müller, N 139; Hauser, Schweri and Hartmann, § 3 N 4; cf. also Osterkamp, pp. 231 et seq.

[68] Druey, p. 135.

[69] Cf. Schmid, N 13; Druey, pp. 144 and 148.

of a crown witness provision, and to the counter-argument of misgivings about the rule of law. Thus the dialectical tension engendered by a crown witness provision is primarily demarcated by rule-of-law requirements, on the one hand, and policing demands, on the other.

Various arguments advanced against a crown witness provision – e.g. the danger of false incrimination – are valid even in the absence of a crown witness provision, wherever investigative assistance is rewarded as cooperative behaviour within the framework of general sentencing.

The arguments put forward against a crown witness provision must also be measured in terms of whether their envisaged purpose could be accomplished *de lege lata* without a crown witness provision. The sentencing provisions in the Swiss law currently in force, with the probable exception of Art. 260ter para. 2 StGB, are not appropriate to give a Swiss crown witness any equivalent certainty of sentencing concessions.

Furthermore, the arguments put forward make it clear that considerations of utility and the precepts of justice cannot be seamlessly reconciled. The risk in resolving the dialectical tension is that the interest in the functionality of criminal justice, particularly in cases of serious crime, attains such weight that any other counter-interests of greater weight are barely imaginable. In that case, the outcome of the balancing test would be pre-programmed to a certain extent. In the case of crown witness provisions, however, the argument of the functionality of criminal justice has to be qualified. In essence, it is not about the functionality of criminal justice as a whole, but about certain cases in which the prosecuting authorities face an investigative necessity. A complete failure of state criminal justice is not at issue.

Moreover, functional criminal justice must also always be justice-like. In a rule-of-law state, the end does not sanctify all means. Further, it must be noted that no principle, not even the legality principle of criminal procedure, can claim absolute precedence over others. If two principles conflict with each other, one principle *must* give way in order to allow another to prevail. However, it must constantly be borne in mind that procedural maxims developed in a long historical process are not an end in themselves.

After a balancing test of the different arguments, the conclusion can be drawn that a crown witness provision in Swiss criminal law applicable to serious crime is a justifiable compromise between rule-of-law and policing considerations in the event of an investigative necessity that appears to pose a threat to the rule-of-law state. This applies specifically to particular forms of organised crime and to terrorism.[70]

[70]Cf. Koumbarakis, marg. note 356.

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Part IV
Economic Analysis in EU Law

Chapter 12
The Case for a Principled Approach to Law and Economics: Efficiency Analysis and General Principles of EU Law

Aurélien Portuese

Abstract *Arche* which in Ancient Greek means *beginning* or *principle* shows the common lineage between the study of principles and the beginning of a study: the enquiry into the nature of things starts, and should start, from the deciphering of the principles, be they of things or of law. This is also true for the general principles of law regarding the study of any legal order, and particularly of the EU legal order. Specifically, I shall demonstrate in this essay that the social influence those principles may have is to coherently formalise the EU judicial reasoning by the promotion of a notion of economic desirability when these principles are invoked. In other words, I shall argue that the principle of economic efficiency underpins each of the general principles of EU law analysed in this essay. For, the general principles of EU law as construed and interpreted by the EU judges are imbued with consequentialism rather moralism, with an analogical and practical reasoning rather than abstract reasoning, with an inductive rather than an deductive approach – in short, these principles are founded with pragmatism rather than with legalism.

Indeed, the analysis of the general principles of EU law understood in their legal abstraction is neither relevant nor conclusive for a better understanding of the EU judicial reasoning. These principles are a mere conceptualisation of the EU judicial review in order to trim down the legal outcomes preferred in terms of the social consequences they (are supposed to) generate. This conceptualisation allows for an *a posteriori* legal justification to a legal outcome decided a priori. In sharp contrast to Wechsler's argument that general principles of law encapsulate "what surely are the main qualities of law, its generality and its neutrality", one can agree with Holmes who said, regarding the Common law judge, that judges "decide the case first and determines the principles afterwards".

Accordingly, after having delved into the plea that vouches for a more principled economic analysis of EU law (but also more generally of any legal orders) that

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would take place beyond the Dworkin-Posner dichotomy (1) and (2), I shall empirically scrutinize, through a casuistic analysis of the ECJ jurisprudence, the validity of the proposed approach of efficiency analysis of three general principles of EU law (3). I close the essay with some concluding remarks (4).

12.1 Legal Deconstructiveness Versus Legal Formalism: The Posner-Dworkin Debate

Do legal principles have per se an anti-efficiency rationale, or at least have an efficiency "neutrality"? This query is directly derived from the academic debate that has emerged between Posner[1] and Dworkin.[2] The former denies the existence of legal principles in favour of legal rules that are explainable most of the time from an efficiency perspective. The latter sees the law as formed by legal principles derived from higher nature and that applies (potentially with legal rules) on grounds of moral values rather than on efficiency grounds.

The debate involving Posner and Dworkin (and more generally between legal realists or economists and legal formalists) pares down to the role of the judge in law-making process, and more particularly the range of judicial discretion that judges have and should have. Judges are generally seen as rule-appliers (as argued by legal positivists) and occasionally rule-creators (as argued by legal realists). Hart,[3] a positivist legal philosopher who highly influenced Posner's legal philosophy, described the legal order as a system of rules fitting into two categories: the primary duty-imposing rules (for establishment of legal duties such as in criminal law) and the secondary power-conferring rules (themselves divided in three categories: the rules of adjudication for judgments depriving liberty; the rules of change for transactional relationships; the rule of recognition for ascertaining the validity of other rules). Hart recognises some "minimum content of natural law" even if he positions himself strongly as a positivist, seeing law as having autonomously emerged from morality.[4] From this minimum content, principles belong to the residual duties of the law that are "most commonly accounted 'moral'" prescriptions.

Judges decide cases by choosing some legal rules over others according to different considerations, be these considerations grounded upon legal justification or utility-maximizing whereby judges would satisfy their personal preferences by delivering of specific judicial decisions. Judges have the power to choose the legal rules in order to avoid possible legal gaps by recourse to what Cardozo calls the

[1]Richard Posner, *Problems of Jurisprudence*; Richard Posner, *The Frontiers of Legal Theory*.

[2]Ronald Dworkin, *Taking Rights Seriously*; Ronald Dworkin, *Justice in Robes.*

[3]Herbert L.A. Hart, *The Concept of Law.*

[4]Herbert L.A. Hart, *The Concept of Law.*

"jural principles".[5] These principles are statute laws that are so determinate that for the judge to ignore them is to adjudicate illegally because the legal interpretation was clear. For, "judges employ discretion to change rules, and discretion is not 'principled', although it may be bounded by principles".[6] Thus, the judicial reasoning is not and cannot be derived from grand principles applied casuistically; even if the possible principles that Posner refers to as possibly being binding to judges are mainly found in *stare decisis*. This "principle" in Common Law implies that a judge is bound, not by moralistic principles, but rather by a "principle" of administration of justice, that is the binding power of higher courts' decisions on like cases to the one presented before the court. The law decided in cases breathes from the vitality and change of legal rules[7] rather than settled principles of justice defined abstractly and permanently. In that regard, Cardozo said that "few rules in our time are so well established that they may not be called upon any day to justify their existence as means adapted to an end. If they do not function, they are diseased. If they are diseased, they need not propagate their kind."[8]

The legal changes must take place at the rate of social changes to keep their desirability based upon social legitimacy intact and they do not have to be subsumed for consideration of traditional "integrity" and consistency throughout the times. Instrumentalism rather than integrity characterize legal pragmatism.[9] "As nation changes", Posner argues that "judges, within the broad limits set by the legislators and by the constitution makers, must adapt the law to an altered social and political environment [...]. They need the instrumental sense that is basic to pragmatism."[10]

Legal changes that are instilled by a sort of "social Darwinism" whereby customs and cultural preferences are selected through evolution and to which a new selection of legal rules must follow. The "legal Darwinism" is said to be in Posner's language part of the new legal pragmatism he has proposed over two decades.[11]

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[5]Benjamin N. Cardozo, *The Nature of the Judicial Process*.

[6]Posner, *Jurisprudence*, p. 21.

[7]The prediction theory of the law asserts that law is simply the legal rules predicted to be produced by judges. Holmes has been the most prominent scholar developing this theory, which views judges as "interstitial legislators" predicting the activity of other judges. "Most judges try to avoid being reversed, and this commits them to the prediction theory", Posner, *Jurisprudence*, p. 224, affirms, whereas one can argue that judges in highest courts are also committed to this theory because they avoid being overruled by the legislator or the constituent who could use what Pollack in the EU call the "nuclear option".

[8]Cardozo, pp. 98 et seq.

[9]Beside instrumentalism, legal pragmatism is characterized by contextualism, anti-foundationalism and perspectivism, Thomas Cotter, 'Legal Pragmatism and the Law and Economics Movement'.

[10]Posner, *Overcoming Law*, pp. 402 et seq.

[11]To be precise, Ronald Dworkin, 'Darwin's New Bulldog', dubs Posner "Darwin's New Bulldog". Posner has developed at length his vision legal pragmatism that takes wealth maximization as one criterion of justice but not an exclusive criterion, and more importantly takes a strong forward-looking, consequentialist-based "soft" positivism of law in a predominantly rational choice perspective, Richard Posner, *Problems of Jurisprudence*; id., *Law, Pragmatism and Democracy*;

Posner's criticism against judicial discretion employed under the disguise of the veil of moral values, legal principles, or even behind the justification of interpretivism,[12] leads Posner to express great scepticism toward legal principles (and legal standards hastily considered tantamount to principles) because they participate to the detrimental formalist legal reasoning of top-down approach whereby syllogism could be the correct mean for delivering a "right" answer. Hence, Posner acknowledges the benefits of standards (or principles) while fearing the judicial discretion it provides for judges:

> The standard solves that problem – the problem of achieving substantive justice rather than merely formal justice – but, by vesting broad discretion in the officials applying it, it opens the way to abuse [. . .] Rules create pressure for ad hoc exceptions, but standards could be thought the very institutionalization of the ad hoc exception. In a regime of standards, the principles or policies that in a regime of rules would determine the content of the rules are used to determine the outcome of particular cases.[13]

Dworkin, by opposition, proposed a theory of law characterized by highly defined concepts that are both sources of law (descriptive interpretivism) and tools for adjudication (normative interpretivism). His perspective tries to go beyond medieval natural law theories and positivism personified by authors such as Hart, Austin, Kelsen and Bentham (and other forms of utilitarianism as suggested by Posner) who are all part of what he calls the *ruling theory of law* (for their emphasis of positive legal rules as main research interest in the law). Dworkin considers that the law is not only constituted by (primary or secondary) rules as Hart[14] suggested, but is made of principles derived from higher source of law, mainly from moral origins.[15] These sources of law provide clear-cut answers to legal disputes: the

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id., *How Judge Think*. His position is best defined in a nutshell by himself when he argues: "I am also not a 'strong' legal positivist, as Holmes was; indeed, I resist the effort to dichotomize positive and natural law. My position owes more to philosophical pragmatism than did the realist movement. If I had to choose I would range myself on the side of the sceptics, but the pragmatic approach may enable the conflict between Legalists and sceptics to be transcended.", Posner, *Jurisprudence*, pp. 32 et seq.

[12]In that regard, Posner, *Jurisprudence*, pp. 457–460, affirms that "if epistemology and ontology will not save the law's objectivity and autonomy, neither will hermeneutics [. . .]. There is no longer a useful sense in which law is interpretive [. . .], there are no 'logically' correct interpretations; interpretation is not a logical process". Interpretivism is personified by Dworkin who propose the image of the so-called "chain novel" for judicial interpretation of the law. According to this view, each judge would write down a new chapter of the grand novel that is law after what previous judges have written reminiscent chapters. This backward-looking perspective of legal interpretation is obviously possible only if "principles" of adjudicating justice are defined, widely known, and consistently respected. Thus, comes the necessity to find "principles" of higher and stable nature that are greatly respected: morally-laden principles would supposedly do the job. Unpalatable though it may be, the interpretivist theory does clip the wings of the judges' creativity and weaken judicial autonomy, as well as independence, Thomas, p. 7.

[13]Posner, *Jurisprudence*, p. 44.

[14]Herbert L.A. Hart, *The Concept of Law*.

[15]Ronald Dworkin, *Taking Rights Seriously*; id., *Matter of Principle*; id., *Law's Empire*.

judges only have to find these "right" answers.[16] In that respect, the two associated notions of "Rights" and of "Principles" must guide the judges to reach this right judicial solution. Dworkin considers rights as trumps with respect to other policy considerations of decision-makers and should be respected as such either for their utilitarian rationale or for their ideal rationale.[17] As for principles, Dworkin defines a principle as "a principle of law if it figures in the soundest theory of law that can be provided as a justification for the explicit, substantive and institutional rules of the jurisdiction in question".[18] Principles materialise, according to Dworkin, the notion of justice and of fairness. As for policies, Dworkin defines a policy as "that kind of standard that sets out a goal to be reached, generally an improvement in some economic, political or social feature of the community".[19] As for rules, Dworkin affirms that rules are legal norms that are applicable in an "all or nothing fashion".[20] Rules are the function of principles, and principles are prescriptions pertaining to rights whereas policies concern collective goals.[21] Principles are "numberless" and provide guidance for judicial reasoning (similarly to what Cardozo would have called the "directive force" of principles[22]) but only if the desired decision is consistent with precedents.[23] The "adjudicative principle", Dworkin argues, "instructs judges to identify legal rights and duties, so far as possible, on the assumption that they were all created by a single author – the community personified – expressing a coherent conception of justice and fairness".[24]

Derived from his perception of "law as integrity",[25] Dworkin's pretence that there is a right solution and that this solution is reachable associates Dworkin with

[16]Dworkin, *Matter of Principle*, p. 119, initially grounded this "right" answer judges have to give in legal disputes on metaphysical level, thus making Dworkin close to Aquinas theory of natural law. Nevertheless, Dworkin dropped the metaphysical foundations of the "right answer thesis" a year later, Dworkin, *Law's Empire*, p. viii.

[17]Ronald Dworkin, *Taking Rights Seriously*; id., 'Is There A Right to Pornography?'.

[18]Dworkin, 'Social Rules', p. 876.

[19]Dworkin, 'System of Rules', pp. 34 et seq.

[20]Dworkin, 'System of Rules', p. 37.

[21]Ronald Dworkin, *Taking Rights Seriously*; id., *Law's Empire*.

[22]Cardozo, p. 30.

[23]Dworkin, *Taking Rights*, p. 89.

[24]Dworkin, *Taking Rights*, p. 217.

[25]"Law as integrity" belongs to interpretivism and is opposed to both conventionalism and pragmatism. Dworkin, *Law's Empire*, p. 226, anchors "law as integrity" in the domain of legal hermeneutics when he asserts that "law as integrity is different: it is both the product of and the inspiration for comprehensive interpretation of legal practice." Integrity requires a judge to decide specific cases in comprehensive manner thanks to the systematic recourse to principles and requires him to provide "an attractive way to see, in the structure of that practice, the consistency of principle integrity requires". Dworkin, *Law's Empire*, p. 225. Moreover, this integrity is supposed to be preserved by the chain novel metaphor.

legal fundamentalism.[26] These principles (as well as rights) are neither policy-based judgments nor political preferences but, Dworkin[27] argues, the cornerstone of a legal reasoning that "interprets" the law.[28] This alleged mere application of the law favoured by Dworkin assumes that judges do and can distinguish between legal arguments invoking moral principles inherent to the law and political preferences shaping a judicial policy. The dichotomy Dworkin makes is not only between principles and rules (a desirable distinction although not of nature but of degree) but also between principles and policies (an undesirable distinction as the distinction between law and politics is as unconceivable for a legal pragmatism as the distinction between law and moral is for legal formalism). This presumed distinction leads Dworkin to believe that not only judges have to use this distinction but also that they have to be activists (even courageous) through their application of this moralistic law in specific cases.

These moralistic principles are neither created nor modified; they are to be found independently of the period of judging and (almost) independently of the location of judging due to their universalizability. The truth and rightness of the solution provided by judges is derived from the strong assumption formulated by Dworkin according to which the law is determinate[29]: there are no legal gaps possible (an assumption he tries to prove by claiming that judges always provide a solution to each case without considering that they are bound to in most legal orders, otherwise they are subject to disciplinary sanctions). At that point, the Dworkinian perspective on moral-laden principles of law comes extremely close (if not overlaps) with natural law theories. The downgraded judicial discretion advocated by Dworkin derives precisely from the assumption of completeness and determinacy of the law – two characteristics that are widely recognised as being unrealistic when speaking about the traits of the law. Dworkin does not admit that under his approach, judges would have great judicial discretion whereas positivists like Hart[30] explicitly recognise such discretion and advocate it: in these cases, that the rule-making authority must exercise a discretion, and that there is no possibility of treating the question raised by the various cases as if there were one uniquely correct answer to be found, as distinct from an answer which is a reasonable compromise between conflicting interests."

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[26] Indeed, legal fundamentalists share with Dworkin this pretence of a clear and inevitable truth: "legal fundamentalism, then, is essentially an ideology marked by what might be called a closed system of thought in which its adherents believe that they are possessed of the absolute and all-encompassing truth." Thomas, p. 76.

[27] Ronald Dworkin, *Matter of Principle.*

[28] Judges, Thomas, p. 4, argues, not only make law "endlessly" but also make policy "regularly", and the legal theorists who, as Dworkin does, "condemns legal policy-making as an aberrant departure from the true judicial interpretative function also ignore this reality. To some extent, judges have always made policy".

[29] He notably develops this claim in Dworkin, 'Objectivity and Truth', p. 137.

[30] Herbert L.A. Hart, *The Concept of Law*.

Furthermore, is readily accepted that, because of the bombastic distinction between political values that would fall outside the law's ambit and moralistic values that fit within that scope, "Dworkin has created a rich vocabulary for masking discretionary, political decision making by judges."[31] The principles that Dworkin invokes for a theorized legal reasoning are not legal principles in terms of general principles of law as European lawyers know them but rather are principles of justice defined abstractly and ground on a moral theory of law. Moreover, this moralism[32] that Dworkin vouches for must not be the one of the judges in particular, but must be the one of society in general wherein the legal outcomes are delivered. The contradiction of this societal moralism with the universalizability claim is solved, according to Dworkin, by the homogenous preferences with respect to morals of the different societies: because the moral principles are universal, the legal theory as practiced is common to different societies.

It follows from that discussion, that if positivism as personified by Posner in the above debate, sees the legal system as a system of legal rules with little or no difference in authoritativeness with respect to their sources and their nature, then Dworkin understands the legal order as a community of principles that generate rights defined according to moralistic imperatives and that provide for a complete and determinate legal system leaving little room for rule-applier such as judges. The formalistic view of principles as encapsulating the notion of justice and fairness without involving policy and political considerations and from which clear and right answers can be systematically provided, clashes with what I previously called the "nihilist" view of principles specific to law and economics which only sees the autonomy and singularity of legal rules without including them in redundant and authoritative rules that are legal principles. This unsophisticated contradiction can only be exaggerated were a middle-ground approach could be welcomed. This approach would lie upon a refined law and economics approach whereby the focus of study is not only legal rules but, more comprehensively, the legal system, thereby including legal principles acknowledged as a matter of law. Beyond "law as integrity" or what could be called "law as scattered rules", there is greater avenue for a "law as principled efficiency". Before examining empirically the jurisprudence of the most important principles of law from an efficiency angle of the most influential legal order in Europe – the EU legal order – it is now necessary to detail the conceptual bedrocks of such a line of attack in terms of legal philosophy.

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[31] Posner, *Jurisprudence*, p. 23.

[32] Ronald Dworkin, 'Philosophy, Morality and Law – Observations Prompted by Professor Fuller's Novel Claim'; id., *Law's Empire*, views the rightness of legal prescriptions according to their linkage with moral conventions (in opposition to Fuller's perception of the "internal morality of law"). His moralism is also called "moral realism" according to which law is seen formalistically as enforcer of moral principles that are clear and provide clear legal answers. There is one morality leading to one legal theory providing one right answer to a specific case. This "moral absolutism", Posner, *Jurisprudence*, p. 201, is a strongly anti-relativistic and anti-sceptic view of the law as defended in Michael Moore, 'Moral Reality'; id., 'Moral Reality Revisited', and criticized in Larry Alexander, 'Striking Back at the Empire: A Brief Survey of Problems in Dworkin's Theory of Law'.

12.2 The Case for a Principled Law and Economics

My contention is to say that, one can understand legal principles as such from an efficiency viewpoint, and see whether or not they encapsulate an efficiency rationale. Legal principles do exist beside legal rules. But, legal principles do not emerge from moral or higher nature (a top-down approach) but rather as a bundle of legal rules that are sufficiently settled to be self-argumentative (a bottom-up approach). In that respect, the preservation of the positivist distinction between law and morality is needed because of the convincing difference in the nature of those two intellectual spheres. Since legal principles are a bundle of legal rules (in this essay we saw that the proportionality principle is a bundle of three legal sub-principles/rules), it becomes very probable that an efficiency rationale will support them.

The argument according to which legal rules approached in isolation may entail greater and more precise legal commands compared to legal principles overlooks both the vagueness of legal rules[33] and exaggerates the distinction of the nature of rules and principles. A relative objectivity in legal reasoning can be pushed forward even when legal principles are invoked, precisely because (i) legal principles are a bundle of legal rules, (ii) legal principles have jurisprudentially emerged through time by the repeated practice of adjudicating activity in a specific legal order. A principled approach to law and economics means nothing less than a pragmatic approach to principles of law. They are integrated in the study of law according to legal pragmatism not because of their moral authoritativeness but rather for their functional usefulness – usefulness not even logically proclaimed but repeatedly demonstrated through numerous empirical litigants' claims and consistent jurisprudential preferences. The emergence of the usefulness of these principles is due to the evolutionary bottom-up approach during the course of the practice of judicial activity. The jurisprudential practice legitimize, from a dynamic perspective, the legal rules, some of which shall be deemed so useful and so often invocable in different situations that they happen to be called "principles of law". Instead of being stranger to the formation and composition of principles either because legal formalism commands them to apply principles as moral imperatives or because legal positivism proposes to judges that are to be picked up among other sources of law, pragmatist judges should view legal principles as legal rules strongly (but not entirely) entrenched into the legal order and bundled together within a coherent ground of legal argumentation. Thus, these principles are perceived in dynamic manner where judicial creativity continuously reshapes their application with, possibly, their removal whenever their functionality in light of social arguments has waned to a great extent. There cannot be a judicial search for the original intent of these principles since they are judicially created and

[33] While praising the more bottom-up legal reasoning based upon simple legal rules without the syllogistic bias of formalists principles, Posner, *Jurisprudence*, p. 47, recognises nevertheless that "decision according to rule is not inherently more objective than decision according to standard; the principles and the ad hoc are not, in law, as polar as the terms connote".

regularly modified: the judicial search when principles are invoked boils down to the relevance of using such principles to the dispute at hand and the adaptability of these principles to the situation. Judicial reasoning, if any, is about making the law and sometimes the structural (not necessarily conceptual) aspect of it: legal principles. Because uncertainty is "inevitable", Cardozo reflects this idea of judge-made legal principles as a (timid) tool to reduce uncertainty:

> I have become reconciled to the uncertainty, because I have grown to see it as inevitable. I have grown to see that the process in its highest reaches is not discovery, but creation: that the doubts and misgivings, the hopes and the fears, are part of the travail of the mind, the pangs of death and the pangs of birth, in which principles that have served their day expire, and new principles are born.[34]

The newness of legal principles is neither "good" nor "bad", but simply required. Society, or the plethora of litigants that come before courts to express themselves, asks for new ways of adjudicating the law so that legal arguments that are put forward before the bench are better heard. This claim is transformed by the judicial production of the law into the new principles presented to the society as better suited to their preferences. Novel as these principles may be, there are nevertheless (re)construed without a *tabula rasa* approach but rather with the unbundling of the legal rules these principles were composed of and with a reshuffling of some of these rules while others may vanish. Legal principles are malleable, according to the pragmatic judge, only to the extent that intellectual honesty is untouched. To alter the famous expression ("old wine in new bottles"), the old bottles cannot serve new wines when these new wines were not originally thought to exist and when these old bottles give a taste of the old wines when the wine is served.

Unlike Dworkin, the pragmatic judge neither considers that principles must prevail over rules nor does he consider principles and rules different in their nature and their functioning – both are legal arguments used in similar ways and there is no strict qualitative hierarchy of these two legal norms only principles do arise quantitatively more often than rules do. This being said, rules may acquire even greater authoritativeness in terms of legal arguments compared to new principles not empirically tested. The departing line, instead of being the height in the sources of law as Dworkin would recommend, is the empirically practicality of each legal norm. Like Dworkin, a pragmatic judge would think that the distinction between principles and rules is both possible and desirable, and that principles yield a higher level of authority within legal argumentation even if this is rarely measurable and hardly automatic. But, legal principles do not necessarily weaken positivism as Dworkin argues,[35] since legal principles are "super-legal rules" or, put differently,

[34] Cardozo, p. 166 et seq.

[35] Dworkin, *Taking Rights*, p. 40, arguing that legal principles are valid according to the "shifting, developing and interacting standards [...] about institutional responsibility, statutory interpretation, the persuasive force of various sorts of precedent, the relation of all these to contemporary moral practices, and hosts of other such standards." The ultimate validity of legal principles are their moral and political rightness – a subjective assessment left to the community.

legal rules so entrenched in the legal system due to their social desirability (with economic, political, ethical, legal or other reasons) that render them sufficiently vague to provide adjudicating enlightenments in quasi-systematic manner. Their social desirability is what makes principles lasting and respected: if this trait alters or disappears, so would the corresponding legal principle. Legal principles are analysed as any legal rules would be analysed, i.e. instrumentally in terms of the beneficial or detrimental effects of their consequences. In that regard, I shall not treat principles "as a matter of principle" as Dworkin would suggest but rather as a "matter of law" due to the fact that, *in fine*, legal principles are a bundle of settled legal rules. Indeed, to view principles as a "matter of principle" is to differentiate them from an analytical legal reasoning integrating the social consequences of such law. Indeed:

> To make something a "matter of principle" means being prepared to act upon something irrespective of the consequences, because it represents a matter of importance in the dimension of fairness, or morality. In the lawyer's case, it is a small step to say that making a case one of principle is making it one whose moral importance consists in the assertion of a legal right.[36]

The economic approach to the general principles of law, and particularly those principles springing from the ECJ case law, can be said to decipher the reality and the economic efficiency of judicial rulings decided on the grounds of those principles.

12.3 An Efficiency Analysis of Some General Principles of EU Law

12.3.1 Principle of Subsidiarity

The principle of subsidiarity is as a double-edged principle (what Alberti, Fossas and Cabellos may call its "bidirectional feature"[37]). Indeed, the principle of subsidiarity can justify further centralization since the principle requires that the most appropriate level of governance should to be chosen for exercising a particular power. As a consequence, the most appropriate level of governance can be either an upper level of decision-making (be it supranational or federal) or a lower level of governance (Leanerts and Ypersele[38]) – hence, decentralization may be founded on

[36] Guest, p. 61.

[37] Alberti, Fossas and Cabellos, p. 103.

[38] Koen Leanerts and Patrick Ypersele, 'Le principe de subsidiarité et son contexte: Etude de l'article 3B du Traité CE'.

the subsidiarity principle.[39] As the common understanding of the principle suggests, we shall nonetheless use the term subsidiarity as synonymous with decentralization in the EU, be they national or sub-national decentralizations.[40]

The principle of subsidiarity governs the exercise of EU powers when Member States share these powers with the EU institutions, as provided by the Treaties.[41] This principle does not tell, as it may have erroneously been argued elsewhere,[42] whether or not the EU has powers to act for a particular policy. When the EU is not competent for a specific field, the EU shall not act in any case within this field of competence; otherwise, the EU is under the risk of illegality. Nevertheless, when the EU has a shared competence, the EU may only act in compliance with the principle of subsidiarity (Article 5.3 TEU). Hence, it is never appropriate for the EU to act when it has no powers whereas it is not always appropriate to act even when the EU has shared powers for intervention. Enshrined in the European Treaties since Maastricht[43] (reaffirmed with the Lisbon Treaty[44]), the principle of subsidiarity has principally been designed as a response to the generalization of majoritarian voting in EU decision-making that took place since the European Single Act. Present in Article 5.3 TEU, the principle of subsidiarity is defined in this Article as a

[39]The subsidiarity principle does not apply to ECJ rulings but only to the EU legislation. Hence, the ECJ's credibility with respect to the introduction of the subsidiarity principle does not seem to be lessened. Jacques Delors affirmed, regarding the Court's credibility, that "subsidiarity in unfortunately a principle which one applies to others and not to oneself", Delors, p. 10.

[40]See Protocol N° 2 on the Application of the Principles of Subsidiarity and Proportionality as annexed to the Lisbon Treaty.

[41]Title 1 of the Part I of the TFEU. The subsidiarity principle is applicable in all areas of the Union competences, except areas dealing with (i) the customs union, (ii) competition policy, (iii) the monetary policy for the Euro-zone, (iv) common fishery policy, (v) common commercial policy.

[42]The literature regarding the principle of subsidiarity is abundant. For instances, Guenther F. Schaefer, 'Institutional Choices: The Rise and Fall of Subsidiarity', who describes this principle as being "basically an empty shell devoid of concrete substance"; Deborah Z. Cass, 'The Word that Saves Maastricht? The Principle of Subsidiarity and the Division of Power Within the European Community', who delivers a more optimistic critique of the principle; Nicholas Emiliou, 'Subsidiarity: An Effective Barrier Against "the Entreprises of Ambitio"?'; Akos G. Toth, 'The Principle of Subsidiarity in the Maastricht Treaty'; Kees Van Kersbergen and Bertjan Verbeek, 'The Politics of Subsidiarity in the European Union'; Vlad Constantinesco, 'Who's Afraid of Subsidiarity?'; Jose Palacio Gonzalez, 'The Principle of Subsidiarity'; George A. Bermann, 'Taking Subsidiarity Seriously: Federalism in the European Union and the United States'.

[43]Article 3b of the European Community Treaty as reformed by the Maastricht Treaty in 1992. The subsidiarity principle has then been incorporated in the Protocol N° 30 of the European Community Treaty by the signing of the Amsterdam Treaty of 1996.

[44]Article 5.3 TEU states: "Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at the Union level. The institutions of the Union shall apply the principle of subsidiarity as laid down in the Protocol on the application of the principles of subsidiarity and proportionality. National Parliaments ensure compliance with the principle of subsidiarity in accordance with the procedure set out in that Protocol."

principle of EU governance along with the principle of proportionality. The EU unsurprisingly interweaves these two principles since they both regulate the exercise of a competence. Hence, they both share the same Protocol – namely, Protocol No 2 on the Application of the Principles of Subsidiarity and Proportionality. Although present in different Articles of the Treaties, the Treaties do not define the principle of subsidiarity. In fact, in the most relevant provision – Article 5.3 TEU – the principle of subsidiarity is better apprehended from the standpoint of explaining the conditions required for the principle of subsidiarity to operate without, however, a definition *in abstracto* in this Article of the principle of subsidiarity. A straightforward description of the principle is thus missing from the European Treaties.

Economics of Subsidiarity

As a basic assumption, it is plain that efficiency gains can be reaped from legal decentralization (subsidiarity). Decentralization delivers efficiency gains unless economic criteria justifying further centralization are met. The reason for further decentralization harks back to the seminal model proposed by Tiebout who dealt with fiscal decentralization and has shown that economic efficiency could be enhanced through political decentralization.[45] Indeed, local governments more optimally provide the local public goods than central governments. Tiebout argued that when individuals have homogeneous preferences and when taxes only concern the persons, a decentralized economy with persons and capital sufficiently mobile, fiscal efficiency might be achieved without central intervention.[46] Inter-jurisdictional competition with respect to taxes brings about economic efficiency since public goods are provided up to amount for which voters have a willingness to pay for.[47] The three general efficiency gains enjoyed through additional decentralization are as follows[48]: First, there is a superior variety of regulations. The main costs borne owing to the harmonization process pare down to informational costs (what Hayek called the "knowledge problem"[49]). Individuals and corporations become able to choose the regulation that maximizes their utility. Allocative efficiency increases because agents can choose the regulation best suited to their preferences.[50] Secondly, decentralization fosters a disciplinary effect on national regulatory systems.

[45] Charles M. Tiebout, 'A Pure Theory of Local Expenditure'.

[46] Charles M. Tiebout, 'A Pure Theory of Local Expenditure'.

[47] Oates takes Tiebout's model further and argues that, even without mobility of economic agents, regulatory decentralization brings about a more efficient outcome compared to the centralization of public goods because of heterogeneous preferences across jurisdictions.

[48] See Sun and Pelkmans, pp. 82 et seq.

[49] Friedrich A. Hayek, 'The Use of Knowledge in Society'.

[50] Barry R. Weingast, 'The Economic Role of Political Institutions: Market-Preserving Federalism and Economics Growth'.

Thanks to the choice of regulations, the administrative and bureaucratic costs of the Leviathan must be limited. The efficiency gains reaped by the disciplinary effect of regulatory competition are intuitive when one compares the government to a monopoly for regulations. Evolutionary efficiency (or dynamic efficiency) of legal transplants and of legal formants[51] is commonly accredited in the literature of comparative law and economics.[52] In this respect, regulatory competition is said to boost overall efficiency for the reason that the most efficient legal rules will be enforced longer and will be generalized through competing legal transplants and legal formants (sources of law, see Mattei[53]). Ultimately, decentralization renders possible an innovative and experimental strategy. Decentralization enables economic agents to discover the best-suited regulation with respect to their needs, in both formal and substantial terms.[54] A real "market for regulations" grants access to previously hidden information thanks to a learning process (informational cost reduction), and in return, this information allows for optimally different local regulation (regulatory efficiency) according to Hayekian reckoning.

On the other hand, the enactment of a harmonized legal rule delivers economies of scale that allows for further efficiency gains. These efficiency gains are materialized by the presence of horizontal externalities deemed internalized and increasing returns of legal production. Most importantly, when preferences of decision makers and/or of voters are (quasi-) homogeneous, then they overlap and allow for a compromised regulation adopted centrally and which maximizes the utility of each jurisdiction relative to the utilities of others'. Legal harmonization may be justified because when a government changes its law in order to comply with foreign legal norms, only this government bears the switching costs. Yet, both governments (the one exporting the legal norm and the one integrating this norm) gain from the scale economies and the transactional cost reduction enjoyed through the lowering of legal divergences. Therefore, each government prefers harmonization through exportation of its own legal norm rather than through importation of new norms due to the avoidance of the great switching costs incurred by this latter alternative. Garoupa and Ogus concluded, with their model wherein two governments exchange goods and services with only one government changing its norms whereas both benefit from this legal change, that a central authority is the only solution to issues of coordination.[55] Thus, governments entrust to this central authority a harmonising power. The mutualisation of the switching costs renders the possibility of avoiding

[51] Ugo Mattei, 'Efficiency in Legal Transplants: An Essay in Comparative Law and Economics'.

[52] Ugo Mattei, 'Efficiency in Legal Transplants: An Essay in Comparative Law and Economics'; Anthony Ogus, 'Competition Between National Legal Systems: A Contribution of Economic Analysis to Comparative Law'; Jan Smits, 'How to Predict the Differences in Uniformity Between Different Areas of a Future European Private Law? An Evolutionary Approach'.

[53] Ugo Mattei, 'Efficiency in Legal Transplants: An Essay in Comparative Law and Economics'.

[54] See for instances Martti Vihanto, p. 415; Francesco Parisi and Larry E. Ribstein, 'Choice of Law'.

[55] Nuno M. Garoupa and Anthony Ogus, 'A Strategic Interpretation of Legal Transplants'.

free-ridership. The reduction in costs of strategic behaviour is greater than the reduction in expected benefits reaped by the maximization of local utilities no matter what. The institutionalization of local government's behaviours through harmonization thus becomes the optimal response.[56] Also, inter-jurisdictional competition is not equivalent to market competition: local governments can hardly bargain over the externalities in a Coasian fashion.[57] Even if Coasian bargaining between jurisdictions could be possible, the resources allocated for this bargaining decrease the overall wealth due to transactional costs.[58] The social cost incurred by the externalities left untouched may render everybody worse off with certainly only one jurisdiction (the polluting one) made better off.[59] A regulatory "race to the bottom"[60] between local governments' regulatory systems may take place with the detrimental effect of over-deregulation.

Consequently, centralization reinforces the function of markets and as a result increases economic efficiency and economic growth.[61] Society puts up with limited governments; decentralized levels of governance have a precedence over regulatory powers whereas the central level of governance (facing budgetary and monetary constraints) limits free-ridership by local governments.[62] Indeed, the efficiency gains and losses attached to both centralization and decentralization render the normativity of the efficiency of the subsidiarity principle rather delicate. There can be no doubt, however, that multi-level governance is the most optimal solution. It is precisely this approach – that is, ensuring the capture of efficiency gains when designing policies in line with the subsidiarity principle – that has been constitutionalized in the European Treaties, as we shall now explain.

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[56] Nuno M. Garoupa and Anthony Ogus, 'A Strategic Interpretation of Legal Transplants'.

[57] See Ronald H. Coase, 'The Problem of Social Cost'; and more generally Robert D. Cooter, 'The Cost of Coase' and Tore Ellingsen, 'Externalities versus Internalities: A Model of Political Integration'.

[58] Mancur Olson, 'The Principle of "Fiscal Equivalence": The Division of Responsibilities among Different Levels of Government'; Inman and Rubinfeld, 'Political Economy', pp. 78 et seq.

[59] Engel, pp. 302–305; Revesz, pp. 1213–1227; Rose-Ackerman, pp. 166–170; James R. Markusen, Edward R. Morey and Nancy Oleweiler, 'Competition in Regional Environmental Policies when Plant Locations are Endogeneous'.

[60] Justice Brandeis has first used the term "race to the bottom" in 1933 in *Ligget Co. v. Lee* (288 U.S. 517, § 558–559). It is interesting to note that Justice Brandeis in his opinion uses indifferently race-to-the-bottom with race-to-efficiency. Esty and Gérardin, p. 30, sum up this idea as: "To the extent that there is a race, it generates welfare gains." William L. Carey, 'Federalism and Corporate Law: Reflections from Delaware', conceptualised the expression in the field of corporate law.

[61] Barry R. Weingast, 'The Economic Role of Political Institutions: Market-Preserving Federalism and Economics Growth', has elaborated "market-preserving federalism"; Yingyi Qian and Barry R. Weingast, 'Federalism as a Commitment to Preserving Market Incentives'. For a thought-provoking critic, see Jonathan Rodden and Susan Rose-Ackerman, 'Does Federalism Preserve Markets?'.

[62] A closely related notion is what Daniel Esty and Damien Gérardin, 'Regulatory Co-opetition', call "co-opetition".

Efficiency Analysis of Subsidiarity Principle

Preliminarily, the Article 5.3 TEU reads as:

> Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at the central level or at regional and local level, but can rather, by reason of scale or effects of the proposed action, be better achieved at the Union level. [...]

From this, we can infer that Article 5.3 TEU encapsulates a double-test for the enforcement of the principle of subsidiarity allowing the EU to act when it has the powers to do so. The presumption is that Member States (be it nationally or regionally according to Article 5.3 TEU) have priority for acting in the fields related to the shared powers category, unless this presumption is reversed so that the EU may act but only if the double-test is passed. This double-test encompasses on the one hand a sufficiency test: Article 5.3 TEU argues, "The Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by Member States". On the other hand, Article 5.3 TEU has a value-added test when affirming that objectives, "by reason of the scale or effects of the proposed action, [can] be better achieved at the Union level".[63] Both tests are cumulative,[64] and the sufficiency test is the *sine qua non* condition to the value-added test.

The sufficiency test is tantamount to an effectiveness test: the EU intervenes if and only if the actions of Member States are either ineffective or inexistent despite the need for action. The EU is then entitled to act if both such action comes as a response to the ineffectiveness of Member States' actions, and if the EU guarantees the effectiveness of its own action. An ineffective action from Member States cannot be replaced by an ineffective EU action – decentralization will always be preferred in case of two ineffective actions. The rationale behind this double criterion is the guarantee of effectiveness inherent to the sufficiency test.

In addition, the value-added test is tantamount to an efficiency test: the EU intervenes if and only if such deed delivers superior net benefits than what Member States' actions would convey. These net benefits can be greater either due to the ineffectiveness of the Member States' actions or due to the effectiveness but less efficient of Member States' actions compared to the actions potentially taken by the EU. A comparative efficiency analysis thus takes place between on the one hand the cost-benefit analysis of Member States' actions, and on the other hand, the cost-benefit analysis of potential EU's actions.[65] The level of governance maximization

[63] Estella, p. 93.

[64] Article 5 of the Protocol on Subsidiarity as proclaimed in the Amsterdam Treaty says: "For Community action to be justified, both aspects of the subsidiarity principle shall be met: the objectives of the proposed action cannot be sufficiently achieved by Member States' action in the framework of their national constitutional system and can therefore be better achieved by action on the part of the Community."

[65] Koen Lenaerts, 'Subsidiarity', defined that the subsidiarity test of the old Article 130r(4) prescribes "a comparative enquiry into the efficiency of the community and the individual Member

of the net benefits is the most appropriate level of legal intervention – hence passing the general test of compliance with the principle of subsidiarity. Consequently, one can summarize and say that the principle of subsidiarity as proclaimed by the European Treaties intrinsically bears an economic rationale underlying its double-test standard. With the meticulous application of this double-test, the principle of subsidiarity encompasses the very notion of economic efficiency and thus contributes through its application, to the promotion of the overall economic efficiency.

Efficiency Analysis of Subsidiarity Principle in ECJ Case Law

The earliest case where the principle of subsidiarity was invoked before the European Courts was the *SPO* case.[66] The General Court legitimately refused to establish the legalism of the principle of subsidiarity before the entry into force of the Maastricht Treaty.

The General Court recognized this legalism in the *Buralux* case.[67] In this matter, the ECJ assured that the principle of subsidiarity does not lead to a restraint on the margin of appreciation left to Member States when dealing with their own powers. Thus, the ECJ rejected the argument by which a Member State has used a too great a margin of appreciation when establishing a national policy – the principle of subsidiarity may merely work up to the bounds imposed by the margin of appreciation of the European institutions in their actions. However, Member States should not be able to be untangled from their obligations of non-restraint of the free transmission of broadcasting in the EU on the grounds of the principle of subsidiarity.[68]

The ECJ has, in the case *Germany v European Parliament and Council,*[69] correctly judged that precisely because of its inability to undertake the test of comparative efficiency, the ECJ is only limited to the review of the reasoning given by the EU legislator for justifying the given EU legal act with respect to subsidiarity. According to Germany, the directive insufficiently defined the legal needs for its existence.[70] For that reason, the principle of subsidiarity is understood here only from a procedural viewpoint. Clearly, it is required that "the measures concerned

States in attaining the objectives of European environmental policy". More generally, this is tantamount to a comparative institutional approach whereby the costs of market failure are weighted against the cost of centralization, Harold Demsetz, 'Information and Efficiency: Another Viewpoint'. See also Pennings, p. 160.

[66]Case T-29/92 (1995) *SPO and others v. Commission*, II-289.

[67]Case C-209/94 (1996) P *Buralux e.a.*, E.C.R. I-615.

[68]Case C-11/95 (1996) *Commission v. Belgium*, I-4115.

[69]C-233/94 (1997*) Germany v European Parliament and Council*, I-2405.

[70]Germany required that "Community institutions must give detailed reasons why only the Community, to the exclusion of the Member States, is empowered to act in the area in question" (§ 23).

should contain a statement of the reasons which led the institution to adopt them [...]" (§ 25). Still, an explicitly mentioned reference to the principle of subsidiarity is nevertheless not required. The ECJ established case law regarding the judicial review[71] of the enforcement of the principle of subsidiarity takes place only for the procedural subsidiarity (i.e. judicial review of the grounds justifying the EU legal act) and not, as we shall later see, for the substantial subsidiarity (i.e. judicial review of the comparative economic efficiency of the litigated act). This EU case law therefore contributes to the on-going "proceduralization" of the principle of subsidiarity by the EU legislator.[72] It seems clear that the judicial review of the procedural side of the principle of subsidiarity only allows the ECJ to leave a very wide margin of appreciation for the EU legislator to intervene when deemed relevant.

At this juncture, one possible explanation for this judicial behaviour could be that the ECJ is incapable of undertaking the so-called comparative efficiency test intrinsic to the principle of subsidiarity.[73] It is only the EU legislator who is able to engage in such analysis. However, the EU legislator has clearly uttered their willingness to uphold the challenged EU legal act. Consequently, the ECJ is reluctant to adjudicate the principle of subsidiarity, cutting this principle down to its core constitution of the comparative efficiency test. The ECJ adopted at the outset of its case law on the principle of subsidiarity, a very narrow approach consisting in accepting a great amount of compliance of the challenged EU legal act with procedural subsidiarity (e.g. not requiring explicit mentioning). The approval by the ECJ to accept only an implicit reference to the principle of subsidiarity in order to review the compliance of a given EU legal act with the principle of subsidiarity means that the ECJ has definitely endorsed a self-restraint judicial review of the principle of subsidiarity. The only fact that the norm alludes to the aptness of its existence suffices for the ECJ to conclude that the EU legislator has correctly enforced the principle of subsidiarity. But, given the cumbersomeness of the EU decision-making process which goes through diverse EU institutions representative of different interests such as supranational (Commission, Parliament) and national ones (Council), how could it be possible that a EU legal act is adopted despite being inappropriate? Therefore, to ensure that subsidiarity has been considered by the EU legislator, it is tantamount for the ECJ to require that the EU legislator show the appropriateness (meaning, the comparative efficiency) of the proposed legal act. This sort of circular argument of the EU judicial reasoning,

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[71] See for instance, C-377/98 (2001) *Netherlands v European Parliament and Council*, I-7079, § 32; C-103/01 (2003) *Commission v Germany*, I-5369, § 47; Joint Cases C-154/04 et C-155/04 (2005) *The Queen, to the request of Alliance for Natural Health et Nutrilink Ltd v. Secretary of State for Health* and *The Queen, to the request of National Association of Health Stores* and *Health Food Manufacturers Ltd v Secretary of State for Health et National Assembly of Wales*, I-6451, § 99.

[72] Bribosia, pp. 54–58.

[73] De Burca, 'Subsidiarity', p. 219, suggests that "the subsidiarity ('comparative efficiency') principle comes into play to determine whether particular aims can best be achieved by the Community or the Member States".

however puzzling, is certainly the most efficient behaviour for the EU judges since this avoids that EU legislative reasoning could be substituted by the EU judicial reasoning.

If the ECJ adopts a hesitant but non-negligible case law on the procedural subsidiarity, it endorses modest approach on case law regarding substantial subsidiarity – a judicial strategy that is consistent with an efficiency rationale, as I shall elaborate below.

Regarding the ECJ case law on substantial subsidiarity, the ECJ, in the *Tobacco II*[74] case, insisted on the need to implement the principle of subsidiarity to the facts of the case that dealt with a directive designed to lift barriers to trade, an objective that could not be legitimately achieved by Member States but only by the EU legislator as argued by the Court. In *Bosman,*[75] the ECJ has decided that an argument based on the principle of subsidiarity cannot justifiably prevail over an argument according to which individuals may be deprived of the fundamental freedoms derived from the Treaties. Accordingly, the ECJ seems to prioritize economic freedoms over subsidiarity. More decisively, in *Working Time Directive*[76] case, the UK asked the ECJ to annul a directive (or to declare null and void some Articles of this directive) that restricted the working-time authorized per week across the EU. In the midst of other arguments, the UK challenged the directive on the ground of subsidiarity. The answer of the ECJ is clear in its readiness to reaffirm its vow on a self-restraint of judicial review when it comes to the principle of subsidiarity. To be sure, the ECJ recognized that "it is to be remembered that it is not the function of the Court to review the expediency of measures adopted by the legislature. The review exercised under Article 173 must be limited to the legality of the disputed measure (§ 23)."

Then, the ECJ expressed its eagerness not to interfere with the EU legislator in its exercise of shared powers between European institutions and Member States. I shall at this point prove that the minimalist, self-restraint EU judicial behaviour on the principle of subsidiarity is the best strategy the EU judge should apply when faced with the EU legislator, given the ambivalent efficiency consequences of the implementation of the principle of subsidiarity. In his book on the minimalist judge, Sunstein argues:

> My suggestion is that the notion of "passive virtues" can be analysed in a more productive way if we see that notion as part of judicial minimalism and as an effort of to increase space for democratic choice and to reduce the costs of decision and the costs of error.[77]

Subsequently, he affirms that a minimalist approach is certainly a minimizing judicial error costs when the context is favourable:

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[74]C-491/01 (2002), *British American Tobacco & Imperial Tobacco*, I-11453.

[75]Case C-415/93 (1995) *Union Royale Belge des Societes de Football association e.a v Bosman*, I-4921.

[76]Case C-84/94 (1996*) United Kingdom v. Council*, I-5793.

[77]Sunstein, p. 40.

> In this light it would be foolish to suggest either that minimalism is generally a good strategy or that minimalism is generally blunder. Everything depends on contextual considerations. The only point that is clear even in the abstract is that sometimes the minimalism approach is the best way to minimize the sum of error costs and decision costs.[78]

The principle of subsidiarity is a principle of governance, not a principle of adjudication. The principle of subsidiarity contains the seeds of the principle of economic efficiency both theoretically (with the economics of multi-level governance) and legally (with the legal reasoning derived from the comparative efficiency test enshrined in the EU Treaties). Yet, the judiciary may not reasonably construe the principle of subsidiarity so that efficiency is maximized due to high asymmetrical information for the judges. Consequently, due to the presence of high error costs in the implementation of the principle of subsidiarity by the Courts given the ambiguity of the economic consequences of the principle of subsidiarity in a specific case, the EU judge minimizes the error costs, while leaving the legislature to minimize the administrative costs through multi-level governance. The settled EU case law on subsidiarity consisting not only in adopting a minimalist approach on substantial subsidiarity, but also in truly reviewing the procedural side of the principle of subsidiarity to maximize the economic efficiency while minimizing the judicial costs potentially created. The disinclination of the ECJ to exercise a judicial review of substantial subsidiarity minimizes judicial error costs since asymmetry of information is high for the Court compared with the EU legislator. On the other hand, the complete judicial review of procedural subsidiarity minimizes the decision costs since the EU judge ensures that the EU legislator has taken into consideration the subsidiarity principle with the efficiency consequences it holds when legislating.

The judge does not hold the necessary information and therefore assumes that the deal struck by the central government has taken into consideration the costs and benefits of a centralized regulation or a decentralized one. Bermann argues that "one's judgment about whether a measure comports with the principle of subsidiarity is a profoundly political one, in the sense that it depends intimately on one's assessment of the measure's merits [. . .] The Court is not, however, especially well-equipped to make [this] substantive judgment".[79]

Consequently, the judge may only bear out the adopted decision, which is thus assumed to have been taken under circumstances with further information than it would be had the judge reconsidered the political decision. Had the judge deemed it necessary to reassess the decision taken by the legislature (or government) to exercise specific powers in a specific pattern, the judiciary would very likely be accused of being a government of judges – replacing the political institutions. After a control exercised by the political institutions which ensure that the EU legal acts are in conformity with the principle of subsidiarity, a second control exercised by the EU judiciary is irrelevant since the EU judges have less information than the

[78] Sunstein, p. 50.

[79] George A. Bermann, 'Taking Subsidiarity Seriously: Federalism in the European Union and the United States'.

EU legislator for exercising this control. Error costs would therefore be largely increased had the EU judges chosen to truly engage in what Bermann calls "a subsidiarity impact analysis".[80] The restrained EU legislative law-making ingrained in the principle of subsidiarity, may legitimately not be opposed by something other than a restrained EU judicial law-making given the ECJ legitimacy problems.[81] This judicial stance shelters the ECJ from the potential criticism of interfering in the political arena, hence avoiding a promising reproach of a "government of EU judges". Each time the European institutions intervene in a particular field, it assumes that only the European institutions are able to bring about betterment in the particular field of intervention (and thus brings about the added value necessary for compliance with the efficiency test of the principle of subsidiarity). Therefore, the study of the economic reasons leading to further harmonisation (such as externalities, homogeneity of preferences, or even regulatory race-to-the-bottom . . .) is cast-off by the ECJ as a ground for judicial review.

The judicial error costs can legitimately be assumed to be important. This is even truer in the case of the implementation of the principle of subsidiarity. Indeed, this principle entails the exercise of some powers to a different decision-maker on a vertical basis. Whereby, once the exercise of a specific power has been delegated to a level of governance, this level cannot accept that their exercise of power be taken away judicially (but only through constitutional changes). The judicial self-restraint witnessed in the ECJ case law on substantial subsidiarity is the most efficient strategy for the ECJ not only because it avoids incurring possible error costs, but particularly for the reason that it minimizes the overall error costs possibly incurred by judicial activism in the field of substantial subsidiarity.

The costs that the EU judges could create had they miscalculated an efficient exercise of powers can be called "Error costs Type I": the judicial error cost of commission. On the other hand, the costs that are potentially borne by the society had the judges left it to the appreciation of the decision makers who would have inappropriately used their information to assign the exercise of powers can be called "Error costs Type II": the judicial error costs of omission.[82] One can legitimately think that the Error costs Type I are much larger than the Error costs Type II. First, the Error costs Type II do not comprise political cost since the judge cannot legitimately be accused instead of legislators of a present vertical misallocation of powers: the legislator can be blamed for the institutional setting that discounts the voters' preferences. Secondly, the Error costs Type II enable a more flexible answer in order to correct an inappropriate exercise of powers since the legislator can

[80] George A. Bermann, 'Taking Subsidiarity Seriously: Federalism in the European Union and the United States'.

[81] Without delving into the immense literature on the EU democratic deficit, see Estella, pp. 43–53, for a survey.

[82] For a similar reference of the two kinds of judicial error costs, see Epstein, p. 45, who criticizes Justice Scalia's willingness to minimize the judicial error cost of commission but fails to consider the judicial error costs of omission.

scarcely surmount a judicial ruling setting out a unmistakable exercise of powers, whereas the legislator can easily remedy a misallocation of powers set out by the legislative branch. Ultimately, and most importantly, the Error costs Type II have a much lower probability of incurring major costs. The EU judges do not grasp, cannot retrieve and are unable to gauge the pertinent information with regards to the most efficient exercise of powers. On the other side, the political branches (in the EU framework, the European Parliament, the Council and the European Commission) have the relevant information and are sufficiently staffed to process such information optimally. As a consequence, it is safe to state that the probability of misuse of information is minimized when the EU legislator, with respect to the EU judges, enjoys a wide margin of appreciation for the decision regarding the exercise of powers between the EU and the Member States. For that reason, the EU judicial self-restraint on substantial subsidiarity is the optimal strategy since judicial error costs are minimized.

12.3.2 Principle of Proportionality

As one of the general principles of EU law,[83] the principle of proportionality is constitutional to the EU judicial reasoning. For that reason, a jurisprudential study of the EU principle of proportionality faces, unlike case law regarding the principle of subsidiarity, no shortness of EU judicial rulings but rather a profusion of EU judicial rulings. As Advocate General Jacobs once said: "As for the principle of proportionality, there are few areas of Community law, if any at all, where that is not relevant."[84] Also, another trait distinguishing the principle of proportionality to most other EU general principles of law is that the EU judges show little reluctance to annul legal acts on the sole grounds of their incompatibility with the general principle of proportionality. The principle of proportionality stands as a general principle of law, more or less explicitly, in virtually all legal orders of the Member States of the European Union – without the non-European legal orders being isolated from this influence. In that section, we shall argue that it is common sense to understand the EU principle of proportionality from an efficiency viewpoint. Indeed,

[83]See e.g. Craig, *EU Administrative Law*, p. 655; Tridimas, p. 136; Nicholas Emiliou, *The Principle of Proportionality in European Law. A Comparative Study*; Bengoetxea, pp. 226 et seq., distinguishes two sorts of uses made by the ECJ of the general principle of law elaborated in the EU legal order. First, EU legal principles may be general concepts helping to judicially interpret Treaty provisions on the distribution of competences and on the obligations of the Member States (e.g. principle of solidarity, principle of community preferences, principle of the unity of the market). Second, EU legal principles may have a more normative dimension for circumventing the liberty of the EU institutions' actions (e.g. principle of protection of fundamental rights, principle of non-discrimination, principle of legal certainty).

[84]Opinion Advocate General Jacobs in C-120/94 (1995) *Commission v. Grèce*, affaire retirée, (§ 70).

the different components of the proportionality principle are better explained when an economic analysis of this legal principle is undertaken. The practicality of the efficiency approach is evident both in the analysis of the possible legal consequences of the cost-benefit analysis (Sect. "From Proportionality to Efficiency Through Cost-Benefit Analysis") and in the very existence of the EU principle of proportionality as enshrined in the EU Treaties (Sect. "Principle of Proportionality as Principle of Economic Efficiency in EU Law"). Finally, a comparative analysis of this principle with the US Supreme Court's jurisprudence definitely proves the necessity of the efficiency approach to the proportionality principle (Sect. "Principle of Proportionality as Principle of Economic Efficiency in the ECJ Case law").

From Proportionality to Efficiency Through Cost-Benefit Analysis

The cost-benefit analysis may be legitimized on different grounds from an efficiency viewpoint – namely, the Pareto justification, the Kaldor-Hicks justification or the utilitarian justification.[85] In the hypothesis of a project making everybody better off without making anyone worse off, the Pareto justification seems to be both positively and normatively appealing. However, the accurateness of such hypothesis is very fragile as "all utility-enhancing government projects probably violate Pareto standard".[86] Those injured by the project can be compensated through side-payments from the winners, but this optimism must be mitigated with the great cost incurred by the institutionalized taxation established and by the great difficulty of identification of the number of losers and their losses' importance. The Kaldor-Hicks justification of CBA[87] delves into the similarity between these two notions: both encapsulate the rationale that winners of the project are able to compensate the potential losers and are still better off, or at least not worse off. However, the two notions differ in the fact that if Kaldor-Hicks encompasses both money and utility as a criterion, the CBA monetizes the calculus and therefore reduces this calculus to the comparison of amount of money. Finally, Adler and Posner identify what they call the "unrestricted utilitarian defence"[88] (which in my eyes, can be incorporated in the Kaldor-Hicks criterion). CBA may be legitimatized by the fact that the social welfare function (the sum of individuals' cardinal utilities) is maximized whenever the increase in the sum of individuals' utilities (benefits) is greater than the increase in the sum of individuals' disutilities (costs) – hence, whenever a project passes the CBA test. It is straightforward to perceive that the tremendous intricacy of the

[85] Adler and Posner, *New Foundations*, p. 19.

[86] Adler and Posner, *New Foundations*, p. 20.

[87] For a critique of Kaldor-Hicks criterion as grounds for CBA at the benefit of a more welfarist criterion, see Matthew Adler and Eric Posner, 'Rethinking Cost-Benefit Analysis'.

[88] Adler and Posner, *New Foundations*, p. 23.

utilitarian calculus involves the assessment of the respective marginal utilities of losers and winners. This marginal utility has been a concept that so far welfare economists were able to define but unable to weigh out.

Regarding the principle of proportionality with the above description of the cost-benefit analysis, it can be argued that the principle of proportionality is the translation in legal parlance of the cost-benefit analysis. Indeed, the proportionality principle requires balancing divergent values as to minimize the administrative burden of a proposed regulation inflicted on the society with respect to any other potentially proposed regulation. This mirrors, in economic language, with the cost-benefit analysis' recommendation of the adoption of the regulation that maximizes the net benefits associated with the proposed regulation with respect to any possible alternative. Proportionality is a measure that, given the overall costs incurred by this measure, generates overall benefits reaped out of that measure that are greater than those costs, and that the net benefits are maximized in comparison with other possible alternatives.

Since the cost-benefit analysis reveals a Kaldor-Hicks efficiency rationale (rather than a Pareto-optimality as outlined above), the view of the principle of proportionality as a Kaldor-Hick efficiency application may syllogistically be endorsed and justified – a justification that is reinforced when the EU principle of proportionality as enshrined in the EU Treaties is detailed, as we shall now consider.

Principle of Proportionality as Principle of Economic Efficiency in EU Law

The principle of proportionality is a general principle of EU law explicitly stated in the EU Treaties[89] in Article 5.4 of the Treaty on the European Union (hereafter "TEU"), this proviso reads as follows:

> Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties. The institutions of the Union shall apply the principle of proportionality as laid down in the Protocol on the application of the principles of subsidiarity and proportionality.

Aside from the Protocol No 2 on the Application of the Principle of Subsidiarity and the Principle of Proportionality which details the implementation of those two principles,[90] the principle of proportionality is present in an array of Treaties'

[89]The principle of proportionality was not part of EU law until the ECJ proclaimed it as detailed below. Fines, p. 45, affirms that this jurisprudential introduction of this principle is perhaps the most significant legal enrichment of the Treaties by the ECJ with respect to EU general principles of law.

[90]Article 5 of this Protocol states that "[d]raft legislative acts shall be justified with regard to the principles of subsidiarity and proportionality. Any draft legislative act should contain a detailed statement making it possible to appraise compliance with the principles of subsidiarity and proportionality". Therefore, a sort of procedural requirement is laid down in this Article in order to ensure that the EU legislator when enacting the measures has considered both principles. This procedural requirement mainly concern "qualitative and, wherever possible, quantitative

Articles.[91] The recognition of the principle of proportionality at EU level in the EU Treaties shows us what Pescatore calls the "constitutional motion" of legal orders.[92] Deriving from internal legal orders of the Member States the general principles of law are necessary for the development of EU law,[93] but the principle of proportionality is specifically "endogenous" to the EU legal order.[94]

Beyond its presence in the European Treaties and its first reference, rather implicitly, in the case *Internationale Handelsgesellschaft,* the jurisprudential evolution clarified the principle of proportionality with different legal tests. These tests, as I shall show, are closely linked to the economic tests inherent to any cost-benefit analysis. The ECJ exercises judicial review of EU legal acts on the ground of the principle of proportionality by scrutinizing whether or not the motivations invoked by the litigated EU legal act fits with the objectives set up in this very act.[95] Although the ECJ willingly review the compatibility of EU legal acts with the principle of proportionality – and for that reason differentiates itself from its approach to the judicial self-restraint endorsed as regards the principle of subsidiarity – the ECJ refuses to judicially review EU legal act on the ground of proportionality when those acts do not interfere with individual rights.[96] Thus, the scope of the principle of proportionality is confined to a legal sphere whereby the litigated legal act creates individual rights and obligations, without it there

indicators" to be expressed in the legislative draft. Oddly, the only provision of this Protocol which concerns the ECJ states that the ECJ can review the compliance of legal acts with the principle of subsidiarity but does not precise the ECJ's juridiction on the principle of proportionality. Indeed, Article 8 of the Protocol reads: "The Court of Justice of the European Union shall have jurisdiction in actions on grounds infringement of the principle of subsidiarity by a legislative act, brought in accordance with the laid down in Article 263 of the Treaty on the Functioning of the European Union by Member States, or notified by them in accordance with their legal order on behalf of their national Parliament or chamber thereof." One potential explanation for this absence may be that the Head of States and governments wanted to emphasize the judiciability of the subsidiarity principle (which was controversial in the literature) while the judiciability of the principle of proportionality would, say, "goes without saying".

[91] These Article are, *inter alia*, Articles 12 TEU and 69 TFEU whereby national Parliaments are required to act in conformity with the principle of proportionality; Article 276 TFEU that prohibits the ECJ to review the proportionality of EU measures in the policy fields of justice and security. Article 296 TFEU provides the applicability of the principle of proportionality in the EU decision-making in cases of legal incompleteness of the EU Treaties with respect to the choice of the decision procedure.

[92] "Mouvance constitutionnelle" in Pescatore, 'Le recours', p. 337.

[93] Pierre Pescatore, 'Le recours, dans la jurisprudence de la Cour de Justice des Communautés Européennes, à des normes déduites de la comparaison des droits des Etats Membres'.

[94] Simon, p. 78.

[95] C-329/01 (2004) *The Queen, to the request of British Sugar plc v. Intervention Board for Agricultural Product*, I-01899 (§ 58); C-426/93 (2002) *Germany v. Council*, I-3723, (§ 42)*; C-491/01 (2002) British American Tobacco (Investments) et Imperial Tobacco*, I-11453, (§ 122).

[96] C-329/01 (2004) *The Queen, to the request of British Sugar plc v. Intervention Board for Agricultural Product*, I-01899, (§ 59).

could not be any legitimate limitation of the legal interference. The intensity of the judicial review on the ground of the principle of proportionality becomes null whenever the protected interests of individuals are out of reach from said legal act. Consequently, the principle of proportionality solely operates as a principle of limitation of the interference from the public action into the legal corpus of individuals. It is precisely as a principle with a human right flavour that the general principle of proportionality is commonly understood. The historical roots of this principle enlighten its human right dimension. It follows that the binding force of the legal principle of proportionality compared to the binding force of the principle of subsidiarity is much stronger. The principle of proportionality as applied in the EU is very similar to the German proportionality principle. Therefore, the EU proportionality principle can be divided in different sub-principles as follows:

- The review of the necessity of the measures to achieve the desired objective;
- The review of the suitability (or less-restrictive means test) of the measures for the achievement of the objective and
- The review of the proportionality *stricto sensu* whereby the burden imposed must be of proportion with the goal desired.[97]

A theoretical account of the principle of proportionality as an optimization principle, has been persuasively given by Alexy.[98] Alexy distinguishes rules (legal rules) from principles (legal principles) with the criterion of generality,[99] with the criterion of precision in its application,[100] and with the criterion of the prescriptiveness of the norm.[101] But the criterion Alexy endorses does not appear in those criteria that the literature often quotes. Indeed, Alexy considers that the decisive criterion that

[97] De Búrca, 'Proportionality', p. 113.

[98] Robert Alexy, 'On Structure of Legal Principles' and *A Theory of Constitutional Rights*; "Balancing [or proportionality stricto sensu] is a rational procedure in its main part and very close to the reasoning of optimization (or cost-benefit analysis, Pareto optimality)", Van Aaken, pp. 503 et seq., argues.

[99] "[P]rinciples are norms of relatively high generality, and rules are norms of relatively low generality.", Alexy, 'Legal Principles', p. 45. This criterion is found is different works of legal scholars for defining legal principles, and especially for the case of EU law, Bengoetxea, p. 60, sees "[legal principles as] usually general statements contained in legal texts or inductively drawn from them. Because they lack a binary structure, they do not enter into logical relations (or entailment) as readily as legal rules do". Specifically regarding EU law, Pescatore, *Introduction*, p. 120, argued that because of their generality and vagueness, general principles of law are not positive legal rules but only interpretative tools.

[100] This criterion encapsulates altogether "the ability to state precisely the situations in which the norm is to be applied, the manner of creation, perhaps in the distinction between 'created' and 'evolved' norms, the explicitness of evaluative content, connection with the idea of law, or with a high legal statue, and significance for the legal order". Alexy, 'Legal Principles', p. 46, references omitted.

[101] "Principles and rules have also been distinguished by whether they are reasons for rules or rules themselves, or whether they are norms of argumentation or norms of behaviour.", Alexy, 'Legal Principles', p. 46, references omitted.

renders possible to strictly tell apart rules and principles is the "qualitative" criterion that states, "principles are *optimization requirements*".[102] Optimization must here be understood literally – meaning, Pareto-optimal.

Indeed, the first sub-principle of the necessity test requires that only the means necessary to the end pursued be picked up. Therefore, the necessity test is an effectiveness test whereby the means chosen are accepted only because they contribute to the effective realization of the ends. The second sub-principle of less-restrictive means requires that only the strictly necessary means are chosen to achieve the ends – this criterion tackles superfluous regulatory means that would hence incur superfluous costs. Had the production of law been assimilated to the production of goods, this criterion would be the necessary productive efficiency requirement. As, the legal goals are realized with the least cost means and with the minimization of the resources consuming. Finally, proportionality *stricto sensu* requires the balancing of interests (hence of the benefits and costs associated with each of the involved interests) so that the marginal cost created by a violation of a specific entitlement is outweighed by a marginal benefit expected to be greater than this marginal cost. The marginal benefit may very well be derived from the wealth-creation of the marketplace that becomes eased with the lessening of State interventions, or the marginal benefit may be reaped out of the enjoyment of a human right that generates greater marginal benefit than the marginal cost of abridging another human right. Consequently, this sub-principle is by itself encapsulating the CBA reasoning described above.

As the CBA hints to, the objective of this reasoning is not really the pursuing of Pareto-optimality (which is inconceivable with the balancing of costs and benefits) but rather the search for Kaldor-Hicks efficiency.[103] This Kaldor-Hicks efficiency looks after the maximization of net benefits (aggregate benefits minus aggregate costs), which is a slightly different logic than the two first criteria, a minimization of costs only, independently of the benefits. But not only does this criterion tend to promote the maximization of net benefits, it also take into consideration all the other potential net benefits and accepts the measure involving the greatest net benefits possible given all legally and factually possible alternatives.[104] Therefore, this criterion can very well be portrayed as being a comparative efficiency test wherein the different Kaldor-Hicks efficient legal solutions are compared so that

[102] Alexy, *Theory*, p. 47, italics in original. It can already be defined that Alexy considers the rationale of balancing, and more generally the principle of proportionality, to be a rational as a form of legal reasoning, Robert Alexy, 'The Construction of Constitutional Rights'. This rationality is hinted from the optimization thesis of the reading of the proportionality principle.

[103] Kaldor-Hicks efficiency or, synonymously, potential Pareto improvement – if the terminology of Pareto wants to be preserved.

[104] Thus Alexy is right when he states that " the practical significance of the principle theory in the form of optimization thesis is found above all in its equivalence to the principle of proportionality". Alexy, 'Legal Principles', p. 297. Balancing or proportionality stricto sensu optimizes the law through the pursuance of the greatest net benefits possible but in the Kaldor-Hicks sense. Optimization through the proportionality principle as Alexy suggests is basically Kaldor-Hicks efficiency through proportionality principle.

the most efficient only comparatively to all others are selected. If the first two sub-principles fit with Pareto-optimality,[105] the last sub-principle of balancing can only be of Kaldor-Hicks efficiency nature – making therefore the entire proportionality principle as following the Kaldor-Hicks criterion.

As matter of comparison, the United States Supreme Court has developed a proportionality test comparable to the one elaborated in Europe.[106] But if the different levels of scrutiny used by the Supreme Court to review States' legislation may be correlated with the different sub-principles of the EU principle of proportionality, the scattered approach of US constitutional law disallows a comprehensive, coherent and systematic judicial review of States' legislation on the same legal grounds as would allow an systematic application of the proportionality principle to any sorts of legislation.[107] Rather, the US concepts of reasonableness offer a looser judicial review than the EU principle of proportionality.[108] From this comparative perspective outlined without the ambition to be comprehensive, we can nevertheless draw interesting conclusions for our inquiry into the EU judicial reasoning of the principle of proportionality. These conclusions compares the Supreme Court notions similar to proportionality, the different sub-principles of proportionality, and the economic reading we give to these different concepts. The following picture thus appears to us:

Comparative law and economics analysis of the components of the principle of proportionality

	US constitutional law	EU law	Economic interpretation
First tier judicial review	*Rationalbasis test*	*Necessity*	Effectiveness review
Second tier judicial review	*Less-restrictive-alternative principle*	*Less-restrictive-means*	Efficiency review
Third tier judicial review	*Strict scrutiny*	*Proportionalitystricto sensu*	Comparative efficiency review

But has the outlined efficiency rationale of approaching the EU proportionality principle been endorsed by the ECJ?

[105] "The principle of appropriateness [what I call necessity] and the principle of necessity [what I call strict necessity or less-restrictive means] stem from the obligation of a realization as great as possible relative to actual possibilities. They express the idea of Pareto-optimality." Alexy, 'Legal Principles', p. 298. Tremblay, p. 11, argues that the principle of proportionality is a moral principle from the perspective of impartiality. I shall definitely not speculate on the moral nature of the proportionality principle as I adopt a legal positivistic approach that ambition to be distinguished from a moralistic account.

[106] Stone Sweet and Mathews, 'All things in proportion?', p. 20.

[107] Stone Sweet and Mathews, 'All things in proportion?', pp. 4 et seq.

[108] Bermann, 'Proportionality', p. 422.

Principle of Proportionality as Principle of Economic Efficiency in the ECJ Case law

With respect to necessity (or what I call the effectiveness judicial review of the ECJ), the Court has recurrently asserted, "in order to establish whether a provision of Community law complies with [the principle of proportionality], it must be ascertained whether the means which it employs are suitable for the purpose of achieving the desired objective".[109] With respect to the less-restrictive-means test, the Court requires that "when there is a choice between several appropriate measures, recourse must be had to the least onerous".[110] With respect to test of proportionality *stricto sensu*, the Court recurrently declared, as instanced in *Pfizer Animal Health SA v. Council,*[111] that the "disadvantages caused must not be disproportionate to the aims pursued". The *Pfizer* case is highly pertinent here because this case explains the EU judicial reasoning on the sub-principle of proportionality *stricto sensu*, and more general on the principle of proportionality. Indeed, in this case, the Court has explicitly accepted the fact that the third-prong of the proportionality principle is synonymous with a cost-benefit analysis, and therefore deserves to be undertaken as such for the challenged measure to be lastly compatible with the proportionality principle:

> Pfizer argues that the contested regulation was adopted in breach of the principle of proportionality inasmuch as it is a manifestly inappropriate means of achieving the objective pursued and the institutions, which had a choice between a number of measures, failed to choose the least onerous one. Putting forward essentially the same arguments, Pfizer also maintains that the contested regulation constituted a breach of the right to property and a misuse of powers.

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[109] C-84/94 (1996) *United Kingdom of Great Britain and Northern Ireland v. Council*, I-5755 (§ 57). See also, for instances, C-258/08 (2010) *Ladbrokes Betting & Gaming Ltd, Ladbrokes International Ltd v. Stichting de Nationale Sporttotalisator*, ECR I-0000 (§ 50), where the Court explicitly draws for the first time the link we make between necessity and effectiveness, when stating that the national measure must be "compatible with the principle of proportionality, in so far as that measure is necessary to ensure the effectiveness of that [national] legislation"; T-390/08 (2009) *Bank Melli Iran v. Council*, II-03967 (§ 66); C-33/08 (2009) *Agrana Zucker GmbH v. Budesmnisterium fur Land- und Forstwirtschaft, Umwelt und Wasserwirtschaft*, I-05035, (§ 31); C-217/99 (2000) *Commission v Belgium*, I-10251; C-426/93 (1995) *Germany v. Council*, I-3723 (§ 42); C-265/87 (1989) *Hermann Schraeder HS Kraffutter GmbH & Co. KG, Ochtrup v. Hauptzollamt Gronau*, 2237 (§ 23); that there is a "reasonable connexion" between the means and the ends: C-132/80 (1981) *NV United Foods and PVBA Aug. Van den Abeele v. Belgium*, 995 (§ 28).

[110] Joined cases C-254, 255 and 269/94 (1996) *Fattoria autonoma tabbacchi et al. v. Ministerio dell'Agricolture e delle Foreste et al.*, ECR I-4235 (§ 55); Joined Cases C-378 and 380/08 (2010) *ERG and others*, I-0000 (§ 86); C-558/07 (2009) *SPCM and others*, I-0000 (§ 41); C-170/08 (2009) *Nijemeisland*, I-0000 (§ 41); C-534/06 (2008) *Industria Lavorazione Carni Ovine*, I-4129 (§ 25); C-189/01 (2001) *Jippes and Others*, I-5689 (§ 81); C-67/97 (1998) *Bluhme*, I-8033; C-415/93 (1995) *Urbsfa v Bosman*, I-4921; Case 137/85 (1987) Maizena and Others, 4587 (§ 15); C-40/82 (1984) *Commission v. United Kingdom*, 2793 (§ 24); Case 124/81 (1983) *Commission v. United Kingdom*, 203 (§ 16); Case 104/75 (1976) *Officier van Justitie v De Peijper*, 613 (§ 32).

[111] T-13/99 (2002) *Pfizer Animal Health SA v. Council*, II-03305 (§ 12).

> Furthermore, in Pfizer's submission, the Community institutions made errors in the "cost/benefit analysis", in which the costs and benefits to society expected from the action envisaged are compared with the costs and benefits which would apply if no action were taken.
>
> Although the Council does not dispute that in a situation such as this the Community institutions were obliged to carry out such an analysis, it contends that no errors were made in that regard.
>
> The Court considers that a cost/benefit analysis is a particular expression of the principle of proportionality in cases involving risk management. It therefore considers it appropriate to examine the merits of the arguments relating to that analysis together with those concerning breach of the principle of proportionality (§ 407–410).

Also, Advocate General Ruiz-Jarabo earlier referred to the three-pronged proportionality principle and especially to proportionality *stricto sensu* as a cost-benefit analysis when he affirmed that "the principle of minimum intervention, which reflects the principle of proportionality, [is] a concept which has been clearly defined in the case law of the Court of Justice and is founded on appropriateness, necessity and the cost-benefit relationship".[112]

This function of the proportionality principle as an efficiency principle in the sense that it prevents to upholding of national measures having protectionist effects has had its pivotal extent with the *Cassis de Dijon*[113] ruling of 1979. This judgment shifted the focus from a discrimination-based analysis of measures having equivalent effect to quantitative restrictiveness in favour of a cost-benefit analysis of national measures (or balancing in legal parlance). The *Dassonville*[114] principle on the free movement of goods has been clarified by the *Cassis de Dijon* refinement, before itself being circumscribed by the *Keck*[115] exception. On the one hand, the *Cassis de Dijon* ruling allowed the Court to scrutinize more in-depth the costs created by the national regulations as interventions into the market. Proportionate national measures with respect to public goods may impede intra-EU trade due to the entry barriers created for market access. However, this impediment is acceptable since local preferences are satisfied without rendering market access for non-national virtually impossible. But, disproportionate national measures with respect to public goods create costs for the market access that may be amended with marginal benefits derived from the reduction of the regulatory burden that are overall greater than marginal costs of reduction.

On the other hand, almost as a mirror image of the more scrutinous approach of the Court with respect to costs, the range of possible benefits considered by

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[112] Opinion of Advocate General Ruiz-Jarabo Colomer delivered on 14th May 2009, *TeliaSonera Finland Oyj*, I-10717.

[113] Case 120/78 (1979) *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein*, 649.

[114] C-8/74 (1974) *Procureur du Roi v. Benoit and Gustave Dassonville*, 00837.

[115] For similar terminology, see Opinion of Advocate General Trstenjak delivered on 18th of December 2008 for C-531/07, *Fachverband der Buch- und Medienwirtschaft v. LIBRO Handelsgesellschaft mbH* (§ 46).

the Court is widened up[116] thanks to the creation of the so-called "mandatory requirements" which included at the time of *Cassis de Dijon* the prevention of tax evasion, the protection of the consumers, and the prevention of unfair trading. Subsequent jurisprudential discovery of mandatory requirements include the protection of the environment,[117] the improvement of working conditions,[118] and the protection of local cultures.[119] A national measure deviating from the free movement of goods by invoking one of the mandatory requirements expressed by the Court in *Cassis de Dijon* can only be accepted if this national measure is indistinctly applicable[120] to national and imported products (whereas derogations of Article 36 TFEU may apply to distinctly applicable measures) and proportionate. The other legal consequence of *Cassis de Dijon* has been to instil the principle of mutual recognition into EU law whereby, in absence of harmonization rules, the producer of the Home State is no longer required to comply with the regulation of the Host State as long as its products are lawfully marketed in the Home State and are equivalent with the one designated by the Home State's regulation the producer already complied with.[121] With respect to the principle of proportionality, this jurisprudential evolution has led to the increase of judicial scrutiny by the ECJ in its review of national measures in the free movement of goods: the dual requirement of marketing authorization for similar products becomes disproportionate with *Cassis de Dijon*.[122] Given that different regulations are enacted for the protection of the same public goods, the marginal costs incurred by the producers are not outweighed by the marginal benefits expected by this dual requirement. Therefore, with *Cassis de Dijon*, the principle of proportionality as interpreted by the ECJ in its review of national measures can be said to participate in the reform of the State even more than the marketplace. When Maduro argues that the "question is when can the Court legitimately apply the balance test"[123] (understood both as cost-benefit analysis and as a partial application of the principle of proportionality), I answer that the Court is entitled to apply balance test (hence the principle of proportionality) in any of its review of national measures because it is precisely the strength and valence of the

[116]Not as Article 36 TFEU derogations since the Court declared that the derogations enshrined in that Article are exhaustive. See C-113/80 *Commission v Ireland*, 1625 (§ 7).

[117]C-302/86 (1988) *Commission v. Denmark*, 4607.

[118]C-155/80 (1981) *Oebel*, 1993.

[119]Joined Cases 60 and 61/84 (1985) *Cinétheque v. Féderation Nationale des Cinémas Français*, 2605.

[120]C-2/90 (1992) *Commission v. Belgium*, I-4431 (§ 34).

[121]C-120/78 (1979) *Rewe Zentrale v. Bundesmonopolverwaltung für Branntwein* ('Cassis de Dijon'), 649 (§ 14).

[122]National measures found unjustified with respect to the *Cassis de Dijon* formula because disproportionate flourished due to the increased scrutiny of the Court. See C-788/79 (1980) *Italian State v. Gilli and Andres*, 2071; C-261/81 (1982) *Walter Rau Lebensmittelwerke v. de Smedt Pvba*, 3961; C-178/84 (1987) *Commission v. Germany*, 1227.

[123]Maduro, *The Court*, p. 164.

principle of proportionality to apply generally and consistently whereas the different standards of review of the US Supreme Court apply specifically and variably.

The cost-benefit reading of the principle of proportionality has, with *Dassonville*, been developed by *Cassis de Dijon* but mostly refined by the leading case of *Keck and Mithouard.*[124] From the outset, it can be said that Keck does not reverse the overall approach of the Court on Article 34 TFEU but can be seen as reinforcing the cost-benefit analysis reading I give to Article 34 TFEU in combination with the principle of proportionality. Indeed, selling arrangements are caught in the ambit of Article 34 TFEU as costs, but the consideration of the benefits derived from these selling arrangements brings about greater judicial deference toward national measures as long as a cost-benefit analysis is passed. After having enlarged the categories of costs and benefits to integrate into the implicit judicial calculus, the Court took a judicial stance that defined the nature of the benefits in the cost-benefit analysis. This was necessary especially due to the very nature of the cost-benefit analysis: this economic tool is well-known for having an inherent bias which is dichotomy between the relative ease of the measurement of costs compared to the extreme difficulty of measurement of benefits. Costs are often exaggerated while benefits are underestimated. The ECJ incorporated this economic difficulty by drawing a legal distinction in its jurisprudence between "product requirements" (in the ambit of Article 34 TFEU) and "selling requirements".

The benefits resulting from a regulation can be monetary but are most frequently intangible and expressed in terms of preferences. The local preferences (or what Judge Lenaerts call the "fundamental local values"[125]) may be better assessed by local/national regulations, thus maximizing utilities. But, these local preferences are often attached to specific territories. People value the fact that products are processed in a specific way that correspond to their preferences. Therefore, the selling requirements not only affect intra-EU trade very little, but also contribute to the maximization of utilities (substantial benefits) without nevertheless impeding market access for importers more than nationals so that the former are not put in a comparative disadvantage with the latter. Advocate General Tesauro has famously summed up the inherent dilemma of functions of Article 34 TFEU when he wonders: "Is Article [34 TFEU] a provision intended to liberalize intra-Community trade or is it intended more generally to encourage the unhindered pursuit of commerce in individual Member State?"[126]

In *Keck,*[127] the applicants (Messrs Keck and Mithouard) were selling their goods at a loss in France although this infringed a French law indistinctly prohibiting the

[124]See Stephen Weatherhill, 'After Keck: Some Thoughts on How to Clarify the Clarification'; Laurence W. Gormley, 'Two Years After Keck'; Malcolm Ross, 'Keck: Grasping the Wrong Nettle'.

[125]Lenaerts, 'Thoughts', p. 12.

[126]Opinion of Advocate General Tesauro delivered on 27th of October 1993 for *Huenermund* (§ 1).

[127]Joined Cases C-267 and 268/91 (1993) Criminal proceedings against *Keck and Mithouard*, I-6097.

selling of products at a loss. The ECJ took the opportunity of this claim brought by Keck and Mithouard to challenge the French law under Article 34 TFEU to refine its judicial stance on the balancing exercise the Court undertakes when applying the principle of proportionality to national measures under Article 34 TFEU.[128] The *Cassis de Dijon* settled case law is reaffirmed but clarified with the special stance toward the "certain selling arrangements" that national measures regulate. Those selling arrangements are related to the regulation touching upon the locality of the products.[129] Selling arrangements are presumed, in fact as well as in law, not to hinder market access in the internal market.[130] But the *Keck* presumption which protects selling arrangements to be struck down by the ECJ does not allow Member States to enact national selling requirements which could intervene in the market to such an extent so that they becomes disproportionate measures creating unjustified barriers to trade.

In *Familiapress,*[131] the ECJ made clear that weighing of costs and benefits of the measures supposes that the local benefits of the national measures are balanced with the aggregate costs incurred nationally and EU-wide. As a consequence, the imbalance between the costs and benefits very probably leads to striking down the national measure given the local benefits of such measure compared to the widespread costs generated. In *Familiapress*, the ECJ "imposes on the national courts a far-reaching balancing test, in that not only means employed to achieve a (legitimate) objective of national law are to be weighed but also the national aim so pursued against the Community law objective of free movement of goods and the freedom of expression, as enshrined in the Article 10 of the ECHR".[132] The market access rationale of *Keck* applied with reference to the disproportionateness judicial review standard is tantamount to a refined economic reading of Article 34 TFEU whereby the costs of barriers of entry, the market access approach has been generalized to the field of goods. This judicial trend[133] corresponds to an economic rationale since, with

[128]Joined Cases C-267 and 268/91 (1993) Criminal proceedings against *Keck and Mithouard*, I-6097 (§ 14).

[129]Have been considered to be selling requirements, mandatory licences for retailers (C-20/03 (2005) Burmanjer, Van der Minden, De Jong, I-4133); Sunday trading rules (Joined cases C-418/93, 419/93, 420/93, 421/93, 460/93, 461/93, 462/93, 464/93, 9/94, 10/94, 11/94, 14/94, 15/94 (1996) *Semeraro Casa Uno Srl and others,* I-2975); rules prohibiting advertisement on TV by the fuel-distribution industry (C-412/93 (1995) *Leclerc-Siplec v. TF1 Publicité SA,* I-179); a rule requiring authorizations by distributors for the selling of tobacco products (C-387/93 (1997) *Criminal proceedings against Nilsson*, I-7477); rules forcing sellers of a specific product to be settled in a specific territory (C-254/98 (2000) *Heimdienst Sass GmbH*, I-151).

[130]Even if a market access approach has ushered in the case law on the freedoms of movement after Keck, this approach is neither "pure [nor] explicit", Toner, 'Non-discriminatory obstacles to the exercise of Treaty-rights: Articles 39, 43, 49, 18'.

[131]C-368/95 (1997) V*ereinigte Familiapress Zeitungsverlags- und vertriebs GmbH v. Heinrich Bauer Verlag*, I-3689.

[132]Van Gerven, p. 42.

[133]The increasingly reliance on the market access approach based on the principle of proportionality is witnessed with a line of cases such as, for examples, Joined Cases C-34, 35 and

the "rediscovery of the market access approach",[134] not only the cost of intra-trade and/or cost of discriminatory measures are considered, but also are the costs of regulations as such become integrated into the judicial reasoning in these fields of law. On the other hand, the benefits are constituted by all the derogations of Article 36 TFEU plus the mandatory requirements created by the jurisprudence.[135] These costs and benefits are balanced, after the Court has reviewed the legality and legitimacy of the measures challenged, through the principle of proportionality which turn out to be a full-grown legal device ensuring the regulatory efficiency of Member States' measures, and thus, the economic efficiency of the EU economy.[136] The principle of proportionality applied to national measures has allowed the Court to foster a competitive order within the EU through the development of the efficiency rationale of each of the sub-principles of the proportionality principle. Although highly political,[137] the balancing enshrined within the proportionality principle has been and continues to be the only feature ensuring the Kaldor-Hicks efficiency rationale of the judicial decisions of the ECJ rather than the Pareto-efficiency of those decisions (as Alexy defended) since costs are considered by the ECJ bearable as long as the benefits outweigh them – something precisely guaranteed by the wide application of the proportionality principle. The Court has favoured through the application of the principle of proportionality an approach enhancing the economic freedom, and thus the promotion of economic efficiency, over the mere anti-protectionist interpretation of the principle of proportionality when applied to Article 34 TFEU.

Therefore, I can only concurr with Rivers's opinion that "all the court does is maintain an efficiency-based oversight to ensure that there is no unnecessary costs to rights, that sledgehammers are not used to crack nuts, or rather, that sledgehammers are only used when nutcrackers prove important".[138]

But has this wide application of the proportionality principle found its corollary in the challenge of EU measures? This query shall be the one addressed in the next part. I have attempted, in this essay, to demonstrate the efficiency rationale of the

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36/95 (1997) *Konsumentombusmannen v. De Agostini (Svenska) Forlag AB and TV-Shop I Sverige AB,* I-3843; C-189/95 (1997) *Criminal Proceedings against Harry Franzen*, I-5909; C-337/95 (1997) *Parfums Christian Dior SA and Parfums Christian Dior BV v. Evora BV*, I-6013; C-254/98 (2000) *Schutzverband gegen unlauteren Wettbewerb v. TK-Heimdienst Sass GmbH*, I-151; C-405/98 (2001) *Konsumentombudsmannen v. Gourmet International Products Aktiebolag*.

[134]Tridimas, p. 205.

[135]This market access approach is increasingly influencing the case law on freedom of establishment, free movement of persons and freedom to provide services. See Tridimas, p. 206.

[136]For a criticism of the application of the principle of proportionality for its deregulating bias in the field of freedom of establishment, see Nikolett Hös, 'The principle of proportionality in the Viking and Laval Cases: An Appropriate Standard of Judicial Review?'.

[137]Snell, p. 71.

[138]Rivers, pp. 177–182.

EU principle of proportionality, both in theoretical terms through philosophical and comparative approaches, and in practical terms through the jurisprudential approach of the legal developments made by the ECJ.

12.3.3 Principle of Legal Certainty

Legal certainty calls for a legal application to a factual situation that is predictable.[139] Predictability is at the "core" of the principle of legal certainty,[140] and is a notion that overlaps the different dimensions of this principle. Predictability (or foreseeability) in the law encompasses different dimensions, that is: (1) a great reluctance to crafting retrospective laws; (2) the eagerness to have clear and determine laws; and finally but most importantly, (3) the willingness to elaborate reliable laws from a dynamic viewpoint. Recognised expressly for the first time in *Bosch,*[141] the principle of legal certainty has a structural role in the case law of the ECJ as "fundamental principle" of EU law.[142] Thus, the principle of legal certainty is said to be "one of the most important general principles recognised by the European Court".[143] The principle of legal certainty is not interpreted by the Court in a formalistic way whereby this principle would enjoy absolute and categorical imperatives but rather in a pragmatic fashion whereby the practical effects of the lack of predictability are considered in a consequentialist perspective.[144] A definition of the principle of legal certainty is found in *Tagaras.*[145] The EU principle of legal certainty[146] is a "guiding"[147] and "multi-faceted principle"[148] that while "underpinning any legal system"[149] encompasses both notions of legitimate expectations and of non-retroactivity (or non-retrospectivity) of the law.[150]

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[139] See Raitio, p. 128.

[140] Hartley, p. 146

[141] C-13/61 (1962) 13/61, *De Geus en Uitdenbogerd/Bosch*.

[142] C-323/88 (1990) *Sermes*, I-3027; C-234/89 (1991) *Delimitis v. Henninger Brau*, I-935.

[143] Hartley, p. 146.

[144] Indeed, Schwarze, *Droit administratif*, p. 202, affirms that "la prévisibilité ne constitute pas un but absolu dont la méconnaissance invaliderait tous les actes concernés, mais ce sont les retombées d'un tel manque de clareté quant à la situation des administrés qui en déterminant les conséquences".

[145] C-18/89 (1991) *Tagaras c/ Cour de justice*.

[146] Recognised explicitly by the ECJ in C-91/92 (1994) *Faccini Dori*, I-3325.

[147] Salviejo, p. 225.

[148] Raitio, p. 125.

[149] Schermers and Waelbroeck, p. 64.

[150] This distinction between principle of legitimate expectations and non-retroactivity within the principle of legal certainty is not embraced throughout this essay because, as discussed below, the EU principle of legitimate expectations broadly understood encapsulates non-retroactivity of legal rules and is synonymous to the principle of legal certainty.

To sum up, three direct legal requirements follow from the general principle of legal certainty[151]:

- *Determinacy and predictability of the law*. This is for instance illustrated by the *Ireland v. Commission*[152] case whereby the ECJ recalled that "Community legislation must be certain and its application foreseeable by those subject to it".
- *Delayed implementation of the law*. The ideal non-retroactivity and legal rules and of judicial rulings is the legal standard cherished by the ECJ, even though the ECJ does not exclude, as it shall be discussed below, some exceptional cases where justifications (mainly the respect of the legitimate expectations and the protection of the *effet utile* of the legal act) are present. For example, in *Decker*, the EU judges concluded that "although in general the principle of legal certainty precludes a Community measure from taking effect from a point in time before its publication, it may exceptionally by otherwise where the purpose to be achieved so demands and where the legitimate expectations of those concerned are duly respected".[153]
- *Legal coherence*. The unity of EU law is threatened whenever discrepancies of the interpretation of EU law is allowed across national courts, and therefore undermines the principle of legal certainty. This "procedural" legal certainty concerning the internal distribution of law-making powers within the EU falls outside the scope of this essay (concerned with the EU legal certainty in substantive law), and is recapped in *Gaston Schul*: "Difference between courts of the Member States as to the validity of Community acts would be liable to jeopardise the essential unity of the Community legal order and undermine the fundamental requirement of legal certainty."[154]

Principle of Legal Certainty as Principle of Legitimate Expectations

Known in Germany as "*Vertrauensschutz*" or in France as "*protection de la confiance légitime*", the principle of legitimate expectations includes not only the potential needs for transitional measures for the legal change[155] but also, most importantly, the reasonable protection of legitimate expectations derived

[151] Puissochet and Legal, 'Le principe de sécurité juridique dans la jurisprudence de la Cour de Justice des Communautés Européennes'.

[152] C-325/85 (1987) *Ireland v. Commission*, 05041.

[153] C-99/78 (1979) *Weingut Gustav Decker KG v. Hauptozollamt Landau*, 101.

[154] C-461/03 (2005) *Gaston Schul Douane-expéditeur BV v. Minister van Landbouw, Natuur en Voedselkwaliteit*, I-10513.

[155] See C-60/98 (1999) *Butterfly Music*, I-3939; C-11/82 (1985) *Piraiki-Patraiki*, 247; C-127/80 (1982) *Vincent Grogan v. Commission*, 869; C-40/82 (1982) *Commission v. United Kingdom*, 2793; C-42/82 (1983) *Commission v. France*, 1013; C-74/74 (1975) *CNTA*, 550.

from positive law previously promulgated or judicially created. The principle of legitimate expectations emerged in the ECJ case law with the decision *Algera,*[156] before being expressly referred to in 1973.[157] This principle is a general principle thereby concerning any domain of litigation brought before the ECJ, be it the acquired rights by individuals,[158] the EU civil servant cases,[159] and most importantly from a quantitative viewpoint, the litigation of agricultural subsidies.[160] The EU principle of legitimate expectations, as derived from the general principle of legal certainty, is referred more frequently (especially because it is more precise and more limited in scope) by the ECJ. Widely invoked but infrequently successful in challenging legal measure, the principle of legitimate expectations can be invoked only for the contest of institutional actions that are the proximate cause of the legitimate expectation of the litigant.[161] The principle of legal certainty and the principle of legitimate expectations are both acknowledged being, according to the ECJ, "superior rules of law".[162] The principle of legitimate expectations can be understood "as a corollary of the principle of legal certainty".[163] Indeed, Reynolds rightly considers that, in light of the ECJ case law, "legal certainty and legitimate expectations [are] being extremely closely related, almost to the point of considering them to be the same thing".[164]

The Court confuses these two principles and does so legitimately since these two principles are synonymous. The ECJ, from time to time, refers to the principle of legitimate expectations as a "corollary" of the principle of legal certainty: "That principle [of legitimate expectations], which is part of the Community legal order [. . .] is the corollary of the principle of legal certainty, which requires that legal rules be clear and precise, and aims to ensure that situations and legal relationships governed by Community law remain foreseeable."[165]

As a consequence, it is superfluous to distinguish the principle of legal certainty from the principle of legitimate expectations, thus I shall study the jurisprudential approach of the principle of legal certainty through the lens of the principle of legitimate expectations, especially because this approach is more prone to an

[156] C-7/56 (1957) *Algera c/ Assemblée commune de la CECA.*

[157] C-81/72 (1973) *Commission contre Conseil*; C-112/77(1978) *Töpfer c/ Commission.*

[158] C-90/95 (1997) *De Compte c/ Parlement.*

[159] C-289/81 (1983) *Mavridis c/ Parlement.*

[160] C-74/74 (1975) *CNTA*.

[161] Tridimas, p. 252.

[162] C-74/74 *CNTA*, 533.

[163] Schwarze, *Administrative Law*, p. 872.

[164] Paul Reynolds, 'Legitimate Expectations and the protection of trust in public officials'.

[165] C-63/93 (1996) *Fintan Duff v. Minister for Agriculture and Food, Ireland*, I-569 (§ 20). See also more recently C-358/08 (2009) *Aventis Pasteur SA v. OB*, I-11305 ("It should be recalled in that regard that, according to settled case law, the principle of legal certainty, the corollary of which is the principle of the protection of legitimate expectations" at § 47).

efficiency analysis. I shall provide an economic analysis of the principle of legal certainty interpreted form an efficiency perspective as bearing a social cost that is threefold:

- First, *transactions costs* partake in the determination of the efficiency of legal certainty. These transaction costs are constituted by the costs for the institutions draft, monitor and enforce legal changes (or the absence of it) overtime. Here, the seminal paper is offered by Van Alstine who conceptualises the idea of "legal transition costs"[166] that could be described as the switching costs in product markets applied in the market for laws. In economic parlance, the switching costs associated with legal changes create "path-dependency" in the law according to which beneficial legal changes do not occur because of too great of switching costs. It is resource-consuming to adequately and continuously trying to match the legal environment with the social environment.[167] Although this adjustment contributes to the maximization of the social welfare (utility) and hence to the economic efficiency,[168] this promotion of efficiency does not go without transaction costs – a feature too often discarded and that explain legal entrenchments. Finally, transaction costs of legal uncertainty also pertain to error costs of producing these continuous legal changes: whereas the effects of the current laws are well-known (and it is precisely because of their effects that the laws are wanted to be changed), there is a great chance that the new laws may not produce the desired effects, and it is even less sure that they do so timely.
- Second, the principle of legal certainty incurs important *reliance costs* that are the costs for economic actors to invest in assets given the current positive laws. Legal change most of the time is tantamount to an economic loss with respect investments previously engaged by individuals and firms who acted almost as if the law were to be perpetual. Here, the Benthamite notion of propertization of expectations referred above is relevant when reliance costs enter into play. Indeed, optimal investments in rights legally secured generate reliance costs by individuals. Should these investments be lost due to abrupt legal changes, the reliance costs become a pure economic loss of property.[169] This induces parties to under-invest when the dynamic perspective is considered (a consideration better grasped with the notion of risk costs approached below). This stance is frequently considered by judges as in *Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki*

[166] Van Alstine, p. 795, incorporates in "legal transition costs" a large array of costs, such as the learning costs of new laws, the uncertainty costs of lost legal knowledge, the private adjustment costs, and the errors costs of interpretation.

[167] Francesco Parisi, Vincy Fon and Nita Ghei, 'The Value of Waiting in Lawmaking'.

[168] Georgakopoulos, p. 478.

[169] 535 US 722 (2002) at § 739. Obviously, the instance of patent law illustrate the need for properterized expectations so that optimal level of investments is incentivized. In short, "uncertainty is the enemy of innovation" as Justice Newman put it in *Bilski*, 545 US F3d 943 (Fed. Cir.2008) at § 977. More generally, Kelly Casey Mullally, 'Legal (Un)Certainty, Legal Process, and Patent Law'.

Co., Ltd where the United States Supreme Court declared that "fundamental alterations in these rules [regarding patenting] risk destroying the legitimate expectations of inventors in their property". Moreover, legal uncertainty by legal inconsistency or legal unintelligibility increases reliance costs. Indeed, when laws are poorly written or when they are hard to understand, economic actors refrain from relying optimally on these laws and thus bear some *ex post* costs of interpretation that are greater than the saved costs of drafting *ex ante*.[170] In that respect, precise legal rules (creating greater *ex ante* drafting costs) may be preferred from an efficiency viewpoint over vague standards (creating greater repeated *ex post* litigation and correction costs).[171] Reliance costs, as an illustration in the case of legal certainty of incentive costs hampering the dynamic economic efficiency, are the most important type of social cost the principle of legal certainty partakes. The reliance costs of legal certainty are similar to the reliance costs engaged by a contracting party who predicts the applicable law in future situations. Inasmuch as breach of contract can be justified on economic efficiency grounds, breach of legal commitment at the expense of legal certainty can be justified on grounds of efficiency.

- Third and finally, the principle of legal certainty creates *risks costs* in the sense that the risk aversion attitude of the people with respect to the unpredictable legal changes increases the costs for the society to assure itself against unforeseen changes, thereby increasing the overall social cost relative to economic interactions in the current legal framework apprehended aversely by the people. Also, risk-averse people concerning legal certainty means that benefits of legal change are discounted whereas they entail Pareto-improvements. Hence, risks costs of legal certainty partakes both to the costs created by assuring oneself against unpredictable legal changes but also the active reluctance of having legal changes to be adopted even though those legal changes are desirable from an efficiency viewpoint. Because (inefficient) opportunistic behaviour is possible only in time of uncertainties, the unpredictability and inefficiency of opportunistic behaviour induces risk-averse persons either not to enter into legal relationships involving these uncertainties, or would prefer to do so at the condition that a kind of legal insurance is integrated. More particularly, risk-averse persons (the behavioural tendency of the majority) tend to despise bearing the risks alone, and overall, the costs of legal changes. They are reluctant to legal changes because they perceive them as detrimental to their interests, and therefore favour, if there must be any legal change, the spreading of costs of legal change time over time. Polinsky[172] argues, for breach of contract damages, that given the realistic assumption that parties are risk-averse, the optimal risk sharing (or minimization of risk costs)

[170] Van Alstine, p. 833.

[171] See Louis Kaplow, 'An Economic Analysis of Legal Transitions', in particular who points out that when a legal rule must be applied repeatedly and uniformly, then rules over standards are more optimal.

[172] A. Mitchell Polinsky, 'Risk Sharing Through Breach of Contract Remedies'.

is reached when liquidated damages[173] (rather than expectation damages) are awarded. But given that risk costs are not the only costs to be considered in for legal certainty inasmuch as it is the case in contract law, but also given the irrelevance of liquidated damages in the framework of legal uncertainty (since no real contract has been signed literally), the overall optimal solution may diverge from granting liquidated damages. Indeed, as it will be argued, setting up the optimal incentives as well as the preoccupation for minimizing transaction costs may lead to decide to award expectation damages without this solution being inefficient. The gradual change of the law from a temporal viewpoint means, legally speaking, the desirability of only prospective judgements from a risk costs perspective. As for retrospectivity in law, it disincentives investments and therefore reduces economic efficiency from a dynamic viewpoint.[174] But, the retrospective judgments applied to risk-averse people are favoured when they create (exclusively) some advantages at the benefits of the people (e.g. tax reliefs or limitation of sanctions).

Optimal reliance is reached by introducing the criterion of "legitimacy" (which is by no mean different than the one of "reasonableness" in other fields of law) into the principle of legal certainty through the principle of legitimate expectations. Only the legitimate reliance costs shall be covered by the responsibility of the decision-maker for creating uncertainty in the law. As it is the case for contracts, the legal uncertainty (which can easily be assimilated to a breach of contract in the sense that the social contract of binding ability of adopted laws) requires damages to be awarded and these damages are of three sorts. First of all, it can be specific performance whereby the litigants require the institutions to honour the previous law without legal changes – a rather unrealistic possibility since private actors cannot force institutional decision-makers not to constitutionally change the laws. Second, the "damages" awarded can be reliance damages whereby the litigants recover their reliance costs: the plaintiff is compensated by damages which put him in a situation equivalent to the one had he never entered the contract (or here, uses a specific legal rule). Third, expectations damages may be granted which correspond to the entire compensation of missed gains: these damages put the plaintiff in a situation equivalent to the one as he would have been had the contract (or here, the laws) been honoured.

The government costs of mitigation of risks of unrealised expectations are inefficient because people are incentivised to take over-optimal amount of risky investments. Indeed, "the efficient level of investment", Kaplow asserts, "is that induced when investors bear all costs and benefits of their decisions. Therefore, the encouragement resulting from the assurance that compensation or other protection will be provided in the event of change results in overinvestment".[175]

[173] Liquidated damages refer to damages beforehand agreed upon by both parties and included into the contract.

[174] Kaplow, p. 527.

[175] Kaplow, p. 529.

On the contrary, it can be argued that from a consequentialist perspective,[176] expectation remedies ensure not only that the decision-makers (law-makers or judges) fully internalize the costs of repudiating its legal commitment, but also induce decision-makers to perform their legal commitments only if they are economically efficient because legal uncertainty and legal change are still potentially feasible as long as the new legal outcome produces benefits after having compensated for the costs bared by the society.[177] Damages equal the extent of the harmed party's legitimate expectation so that the decision-maker is left free with the possibility of either changing the law with compensations of aggrieved parties or performing the legal commitment in line with the principle of legal certainty.

In other words, the introduction of legitimacy into the principle of legal certainty reflects a move toward optimality in the reliance in the law and altogether the promotion of efficiency in legal changes. Indeed, "legitimacy" of protected reliance here means that only reasonable reliance shall be recovered. But, having the reasonable (or legitimate) reliance protected allows for a more economic approach to reliance.[178] The criterion of reasonableness of knowledge of the law becomes therefore essential for reviewing the compatibility of the legal changes with the principle of legal certainty. In this respect, the reasonable expectations are synonymous with legitimate expectations as not only the law interpreted by the ECJ use reasonableness or legitimacy in expectations interchangeably, but also because, theoretically speaking, what is unreasonable (excessive) cannot be legally legitimate to expect and what is illegitimate is always outside the rationale of justification for expectations. This terminology of reasonableness of the knowledge in the law can very well be substituted to the legitimacy of expectations in the current law (or reliance) and expectations in the possible legal changes (or anticipation).

Therefore, the most important thing to scrutinize is the determination of what is "legitimate" or "reasonable" in the expectations placed in the law in order to reach the optimal level of damages and hence to efficiently incentivize the institution to change the law whenever a breach of confidence is efficient.

Also, the inefficiency of a rule may result from an initial miscalculation from the lawmaker or judge of the expected effects of such rule. In both cases, inefficient rules are enforced despite the desirability here of legal change – hence of trade-off with the principle of legal certainty. On the other hand, retrospective law has some efficiency rationale when various arguments are considered. First, efficiency of retrospective laws pares down to the avoidance of undermining the objectives of legal changes by telling people that indefinite protection of situation by the law is not accepted and therefore it is unnecessary to flood into these activities.

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[176] By opposition of the deontological perspective of contract law which views performance of legal commitments as morally embedded in social interactions. See Zamir and Medina, pp. 292–311.

[177] This argument is analogized from efficient breach of contract as introduced by Polinsky, *Introduction*, pp. 33–36.

[178] Jim Leitzel, 'Reliance and contract Breach'.

Thus, Kaplow affirms that only prospective laws "might induce a flood of investment activity immediately prior to implementation – precisely the activity the reform was designed to discourage".[179] Second, government-sponsored protection of reliance interests is both inefficient (since it takes up the private costs of reliance as public cost of private reliance) and economically unjustified (since the "market uncertainty" can only be correlated with a legal uncertainty where risks are optimally taken by people). In this regard, legal conservatism at any cost cannot be both legitimate and economically desirable. But, the ECJ rightly takes into consideration this necessary weighing of the market uncertainty with the legal uncertainty, and accepts legal uncertainty pleas only when the legitimate expectations are frustrated to an extent that is beyond the usual uncertainty of the economic life or, in the Court's parlance, "goes beyond the limits of the economic risks inherent in the business in issue".[180]

As a consequence, it can be seen that the principle of legal certainty emerged in EU law mainly through the principle of protection of legitimate expectations that encapsulates itself an efficiency rationale. Indeed, the legitimacy criterion allows for telling apart unreasonable claims from reasonable one with respect to the investments incurred in light of previous law. This principle requires compensation damages to be awarded whenever a claim is said to be legitimate and to the extent of the reliance costs incurred (reliance damages) or considering the missed benefits (expectation damages). This outline of the efficiency rationale of the EU principle of legitimate expectations needs to be tested "empirically" by scrutinizing the practice of this principle when implemented by EU judges.

Principle of Legal Certainty as Principle of Economic Efficiency in the ECJ Case Law

Market actors who seek to reduce the uncertainties surrounding them by limiting the legal uncertainty usually invoke the principle of the protection of legitimate expectation arisen from the legal relationships created by institutions.[181] Nevertheless, Member States can invoke this principle accessorily. Indeed, "the principle of the protection of legitimate expectations, which is the corollary of the principle of legal certainty, is generally relied upon by individuals (economic operators) in a situation where they have legitimate expectations created by the public authorities, and cannot be relied on by a Government in order to avoid the consequences of a decision of the Court declaring a Community provision invalid".[182]

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[179] Kaplow, p. 607.

[180] C-152/88 (1990) *Sofrimport SARL v. Commission*, I-2477 (§ 28–29).

[181] See conclusions of Advocate General Trabucchi for the case C-5/75 (1975) *Deuka*, 759.

[182] C-83/99 (2001) *Commission v. Spain*, I-00445 at § 24; C-44/81 (1982) *Germany v. Commission*, 1855.

Litigants are empowered with the possibility to protect particular and clear interests created either by EU legislation or (less frequently) by EU case law. Moreover, if the litigants can have only their specific interests protected, the litigants can only recover the unforeseeable costs created. The notion of "foreseeability by a reasonable man" helps the judges to distinguish the legitimate and illegitimate expectations, and to circumscribe the notion of reliance cost which is at the cornerstone of the principle legal certainty. The foreseeability criterion is not a very demanding one. The remoteness of the costs does not preclude the reliance costs to have been foreseeable by a reasonable man. Consequently, remoteness is not an excuse for the litigant to obtain the award of damages or for the protection of vested interests by stability in the law. But, since the principle of legal certainty only covers unpredictable (hence arbitrary and inefficient) legal changes, the principle of legal certainty does make remote costs recoverable, only the unforeseeable costs are not recoverable.

The existence of important reliance costs incurred by the individuals or firms is the main rationale for the principle of legitimate expectations to enter into play and, if violated, to compensate for the reliance costs. If expectations are protected under the ECJ case law, only those considered to be legitimate receive legal protection. Indeed, as Craig argues that "the mere fact that a trader is disadvantaged by a change in the law will not, in and of itself, given any cause for complaint based upon disappointment of legitimate expectations".[183]

The expectations, in order to be compensated if frustrated, have to be legitimate in the sense that they must have not been foreseeable to a "prudent and discriminating trader".[184] In that regard, the protection of legitimate expectations insures diligent economic actors against the excessiveness (or even arbitrariness) of any actions taken by the administration to change the legal relationships previously settled. For instance, in the *Mulder*[185] case, the Court annulled a Regulation because of its violation of the legitimate expectations of the people to be involved in the legal business in the milk products sector. The claimant, Mr Mulder, a milk farmer, challenged a Regulation for having frustrated the legitimate expectations of milk producers to see their production resumed after a 5 years non-marketing period during which production was suspended because of surplus. The initial system that introduced with Regulation 1078/77 the non-marketing period provided some premiums for producers for them not to market milk or for converting milk production to meat production. During this period, a new Regulation, Regulation 856/84, introduced an additional levy system despite the applicant's investments on the expected resumption of production. The Court observes that the producer "cannot legitimately expect"[186] to resume production years after suspension under

[183]Craig, 'Expectations', p. 306.

[184]C-265/85 (1987) *Van den Bergh BV and Van Djik Food Products (Lopik) BV v. Commission*, 1155 (§ 44); C-78/77 (1978) *Luehrs v. Hauptzollamt Hamburg-Jonas*, 169.

[185]C-120/86 (1988) *Mulder v. Minister van Landbouw en Visserij*, 2321.

[186]C-120/86 (1988) *Mulder v. Minister van Landbouw en Visserij*, 2321.

exactly the same legal regime as before. But, the ending of the period may have nevertheless be legitimately perceived as tantamount to the ending of any restrictions on the farmer's production. Therefore, as the new Regulation in the meantime laid down such restrictions, the Court concludes:

> Contrary to the Commission's contention, total and continuous exclusion of that kind for the entire period of application of the regulations on the additional levy, preventing the producers concerned from resuming the marketing of milk at the end of the five-year period, was not an occurrence which those producers could have foreseen when they entered into an undertaking, for a limited period, not to deliver milk. There is nothing in the provisions of Regulation N1078/77 or in its preamble to show that the non-marketing undertaking entered into under that regulation might, upon its expiry, entail a bar to resumption of the activity in question. Such an effect therefore frustrates those producers' legitimate expectation that the effects of the system to which they had rendered themselves subject would be limited. It follows that the regulations on the additional levy on milk were adopted in breach of the principle of protection of legitimate expectations. Those Regulations must therefore be declared invalid on that ground, and it is unnecessary to consider the other arguments as to their invalidity put forward in the course of the proceedings.

It is clear from the above conclusion that both the reliance costs derived from the claimant's reliance on the initial Regulation and the opportunity costs derived from the potential enforcement of production restriction, are taken into consideration by the Court. Indeed, the "certain investments"[187] made by the plaintiff following the initial Regulation created some vested rights and interests that, if ignored, would have been foregone. In order to preserve the returns on investments, the Court struck down the subsequent Regulations that frustrated the legitimate expectations of the producer by altering the very essence of the initial Regulation – that is, the lifting up of any restriction upon the expiry of the 5 years period. By ensuring that both reliance cost and opportunity costs are protected, the ECJ gave a clear signal for the national court to award expectation damages to the producer in a sense that the producer is entitled to be restored in his position if would have been had the subsequent Regulations not been adopted. In similar vein, the legitimate reliance by an economic operator upon the payment of an aid granted according to a Regulation cannot be frustrated only because this aid was conditioned to the retroactive imposition of a time-limit for forwarding to a regulatory agency of the contracts made as a consequence of this aid.[188] Indeed, the Court declared:

> By retroactively subjecting the payment of aid to the forwarding of the contracts by 31 July 1980 the commission acted in breach of the legitimate expectations of the persons concerned, who, having regard to the provisions in force at the time the contracts were concluded, could not reasonably have anticipated the retroactive imposition of a time-limit for forwarding the contracts which coincided with the time-limit for their conclusion.[189]

The investments incurred by the claimant, in order to comply with their contractual obligations could not have "reasonably" thought to be conditioned

[187] C-120/86 (1988) *Mulder v. Minister van Landbouw en Visserij*, 2321.

[188] C-224/82 (1983) *Meiko-Konservenfabrik v. Federal Republic of Germany*, 2539.

[189] C-224/82 (1983) *Meiko-Konservenfabrik v. Federal Republic of Germany*, 2539 (§ 14).

to a procedural requirement that was both marginal and unclear. Therefore, the economic operator had reasonably entered into these contracts, hence frustrating the contractual benefits of the claimant is tantamount to a breach of the principle of legitimate expectations.

In *Sofrimport,*[190] a similar judicial reasoning has been elaborated. The claimant, Sofrimport SARL, argued that the European Commission could not have legitimately issued protective measures against the import of fruits and vegetables according to Regulation 2707/72, which provides for such protective measures. The Commission, the claimant argued, had to justify on grounds of public interest reasons for such protective measures to be considered justified. In the absence of such justification, the interests of the traders and the protection of their legitimate expectations derived from said Regulation are disregarded and illegitimately frustrated, and therefore breach the principle of legitimate expectations. Consequently, the Commission is liable and must compensate the claimant for the damages incurred as a result of the breach of the principle of legitimate expectations.[191] This principle is a "superior rule of law" that allows precisely for compensation to be awarded in terms of damages for the market actors who are subject to its breach.[192]

The legitimate expectations are the expectations deemed to be "reasonable" even if their expectation have not arisen out of a legally binding act but only by the administration's conduct.[193] Hence, the criterion of determining the successful appeal of the principle of legitimate expectations is "reasonableness". Reasonableness and certainty (or legitimacy in expectations) are intrinsically linked. Bertea portrays the relationship between reasonableness and certainty:

> On the one hand, certainty is associated with uniform treatment, regularity, and predictability: law is certain to the extent that it provides uniform and entrenched generalizations that are relatively blind to the specificity of individual cases. On the other hand, reasonableness is sensitive to particularity and to the concrete form of each case: it tends to admit exceptions to the general and uniform rule. While certainty resembles regularity and uniformity, reasonableness strives for adaptability and flexibility. The two then are potentially conflicting and incompatible ideals that cannot be implemented fully at the same time. Since both are considered basic values in the legal order, each has to be weighed against the other [. . .].[194]

This reasonableness criterion may very well be tantamount to a rule of reason whereby the costs borne by the losers are greater than the expected benefits from the renege of some expectations for the sake of legal change. Thus, the rule of reason grasps the efficiency rationale commonly associate with such a rule. More particularly, the reasonableness criterion inherent to the workability of the principle of legitimate expectations, itself the synonymous of the principle of legal certainty,

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[190] C-152/88 (1990) *Sofrimport SARL v. Commission of the European Communities*, I-02477.

[191] C-152/88 (1990) *Sofrimport SARL v. Commission of the European Communities*, I-02477 (§ 29–32).

[192] Salviejo, p. 249.

[193] C-289/81 (1983) *Vassilis Mavridis v. European Parliament*, 1731 (§ 21).

[194] Bertea, p. 468.

refers to the social optimum whereby the marginal cost of legal uncertainty by repudiating expectations equals the marginal benefit of the legal change. The socially optimal level of legal uncertainty is reached at this level and therefore implies neither absolute legal certainty nor disregard of legal certainty. A moderate and pragmatic approach to legal certainty seems therefore the most direct to adopt a judicial stance that is the most in line with an economic analysis, and more precisely with the principle of economic efficiency. I shall attempt now to demonstrate that this jurisprudential interpretation of the EU principle of legal certainty by the Court matches an efficiency rationale by recourse to the reasonableness criterion of the expectations relied upon by individuals.

The reasonableness of the expectations sought to be recovered is the one of reasonable man, or more precisely of a "prudent and discriminating" trader.[195] This prudent and discriminating trader is an individual invoking expectations "upon the subjectivity of good faith and with objective haste".[196] The bad faith of the applicant in her plea for damages on the ground of the principle of legitimate expectation cannot be accepted when the applicant erroneously interpreted a valid law and did so with little care.[197]

The legitimacy notion in legitimate expectations can be even wider than the legality of those expectations. Indeed, an illegal situation tolerated by an institution for a certain period of time creates legitimate expectations for the people. The administration's conduct that is illegal with respect to a lawful EU act cannot constitute a ground for creating legitimate expectations. And, even if the conduct is said to breach the principle of legitimate expectations, this alone does not automatically lead to the annulment of the challenged act: Naturally, the true legality of the EU measure precludes individuals and firms from invoking their "legitimate expectations" generated in the violation of that legal measure.[198] In the same vein, the lack of enforcement of a EU measure by the European Commission, followed by the continued illegal practice of a Member State due to the this lack of enforcement, cannot be said to have created legitimate expectations. The Member State cannot reasonably rely on this deficiency, be it for 14 years, to claim that it

[195] C-265/85 (1987) *Van der Bergh en jurgens*, 1169 (§ 44) where the Court declares that "the court has consistently held that any trader in regard to whom an institution has given rise to justified hopes may rely on the principle of the protection of legitimate expectation. On the other hand, if a prudent and discriminating trader could have foreseen the adoption of a community measure likely to affect his interests, he cannot plead that principle if the measure is adopted". See also C-350/88 (1990) *Delacre and others v. Commission*, I-395; C-78/77 (1978) *Luehrs v. Hauptzollamt Hamburg-Jonas*, 169 (§ 6) where the Court declares that the contested measure "could not surprise trade circles which, even if they had not yet been aware of the abnormal situation, had at all events been warned by earlier community measures [. . .]. Consequently the adoption of stricter measures was to be foreseen by prudent and discriminating traders so that in the present case they cannot plead legitimate expectation".

[196] "Il faut que la confiance repose sur la bonne fois subjective et la diligence objective", in Calmes, p. 379.

[197] Joined cases T-34 and 67/89 (1990) *Costacurta v. Commission*, 106 (§ 40).

[198] C-67/84 (1985) *Sideradria*, 3983 (§ 21).

was not foreseeable that enforcement may occur since the European Commission has never expressly changed their position.[199] The European Commission, or any administration, is therefore not estopped to enforce that law or to change the law within their margin of discretion of a previously adopted law.[200] The Court consistently ruled that reliance on the non-enforcement of a EU law for a litigant to successfully argue that this inaction has created legitimate expectations can only be "exceptionally" be granted.[201] Therefore, an administrative practice having clearly been in contradiction with positive laws may exceptionally create legitimate expectations. The conditions for the successful invoking of legitimate expectations is that not only that great reliance costs ("serious economic repercussions") are associated with the current practice and would therefore be foregone should the claim be rejected, but also that the generalised practice by administrations of not relying on the positive laws have generated legal relationships based on good faith.

Besides, an illegal EU act can be abrogated – meaning, retrospectively annulled – only during a reasonable period of time after its adoption, otherwise only a reformation or an annulation for the future can be tolerated.[202] In the same vein, the legitimate expectations may exceptionally lead the ECJ to conclude that a EU act illegal in view of the provisions of the treaty creates nevertheless some legitimate expectations for individuals. This judicial stance is to be opposed with the decision by the ECJ to reject the possible legitimate expectations created by a illegal national measures with respect to EU law[203]: illegality of EU measures in the light of the Treaties might not exclude the legitimate expectations created from this illegality whereas illegality of national measures in the light of EU law always exclude the claim of legitimate expectations created by this illegality. Here, the principle of legal certainty is balanced with the principle of supremacy of EU law, at the expense of the legitimate expectations created in the shadow of illegal national measures. As a consequence, the principle of legitimate expectations requires a casuistic approach.[204]

The casuistic approach is illustrated by the fact that the ECJ scrutinizes the nature of the "prudent trader" that invokes the principle of legitimate expectations, looks at the importance of the costs incurred by the reliance to the previous and analyses the importance of the public interest (if any) sought by the institution

[199] C-38/06 (2010) *European Commission v. Portuguese Republic*.

[200] Joined cases C-189/02 P, 202/02 P, 205/02 P, 208/02 P and 213/02 P (2005) *Dansk Roindustri and others v. Commission of the European Communities*, I-05245 where the Court declared that the principle of legitimate expectations does not preclude that the "Commission, in the past, imposed fines of a certain level for certain types of infringement does not mean that it is estopped from raising that level within the limits indicated in Regulation 17 if that is necessary to ensure the implementation of Community competition policy". See also C-315/96 (1998) *Lopex Export GmbH v. Hauptzollamt Hamburg-Jonas*, I-00317 (§ 27–31).

[201] C-239/06 (2009) *European Commission v. Italian Republic*.

[202] C-15/85 (1987) *Consorzio Cooperative d'Abruzzo c/ Commission.*

[203] C-83/99 (2001) *Commission v. Spain*, I-445 (§ 24); C-316/86 (1988) *Krucken*, 2213 (§ 23).

[204] Opinion of Advocate General Trabucchi in C-5/75 (1975) *Deuka*, 759.

for the enactment of the new legal rule. This *in concreto* approach of the ECJ reveals its eagerness to balance the costs generated by the contested regulations with the benefits of greater flexibility in the law, together with the achievement of the public interest.[205] The repeated reference by the Court to the "prudent and discriminating trader" forces market actors to adapt their behaviour (hence their subjective appraisal of the law and administrative conducts) so that an optimal reliance in the legal relationships created is reached. This optimal reliance is, legally speaking, enshrined by imposing the standard of legitimacy in the expectations such "prudent and discriminating trader" may have. As a consequence, the trader advances an ever-increasing minimization of the regulatory costs (by forcing the administration not to create expectations leading to compensation if frustrated) and of the reliance costs (by forcing the trader not to excessively and superfluously invest as if market uncertainties and the correlating legal uncertainty were absent). Such restrictions in the administration's actions, while promoting an optimal level of investments by market actors in the law, are conducive to enhancing dynamic efficiency of the market economy by making the institution liable for damages.[206] In short, the principle of legitimate expectations as devised in EU law and as interpreted by the ECJ participates to the fostering of economic efficiency.

The role of the judges is enhanced through the application of the principle of legal certainty, and more particularly of protection of legitimate expectations, because of the necessary casuistic protection of individuals' rights against the unreasonable interventions by the institution into the legal corpus.[207] But, this judicial discretion exercised in light of the diverging interests that have to be balanced is in practice explained by the minimisation of the social cost. The cost in this particular instance concerns on the one hand the reliance costs of the incurred by individuals who have relied on the previous law as well as the opportunity costs in terms of missed benefits due to the frustrated realisation of the consequences attached to this previous law. On the other hand, the cost concerns the missed benefits of the supposedly expected better law. The EU judicial reasoning, in that regard, it has been shown, is typified by a disposition to allow for legal changes at the condition that two cumulative requirements are met. First, the quality of the legal change, in terms of legal clarity and consistency, must be sufficiently evidenced in the specific case. Second, and most importantly from a dynamic efficiency perspective, the efficiency of the legal change, in terms of expected net benefits (benefits minus the expectations damages awarded to frustrated litigants and third parties) are greater than the current law.

This judicial stance of the ECJ is illustrative of the importance given to the principle of legitimate expectations within the principle of legal certainty, but more significantly, is illustrative of the very efficiency rationale inherent and interpreted as such by the ECJ.

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[205] In that regard, see conclusions of the Advocate General Cosmas for the case C-89/98 (2000) *France v. Ladbroke Racing Ltd and Commission of the European Communities*, I-3271 (§ 89).

[206] We have seen with for instance that was the case in the CNTA case: C-74/74 (1975) *CNTA*, 533.

[207] Bertrand Mathieu, 'Réflexions en guise de conclusion sur le principe de sécurité juridique'.

12.4 Conclusion

In conclusion, it has been empirically shown that not only a more principled approach to law and economics is desirable (Part II) but also that this approach is possible, notably at the EU level (Part III). The three general principles of EU law have been only examples of an empirical study (as they are other general principles of EU law) that calls for further researches to adopt this approach within and beyond the field of EU law.

This principled approach has the advantage of being, first, more illustrative of the practice of the law in courts where general principles are important grounds for review, and second, allows for a greater familiarity for "traditional" lawyers with the economic analysis of law. This approach reconciles legal economists and lawyers through a better account given to the practice of legal theory for the former while the latter grasps the economic approach to well-known and familiar concepts. Furthermore, the approach contains benefits that go beyond its mere usefulness, as this approach would be better acquainted, with further research, on the notion of a hierarchy within the legal order – particularly with the stability of some legal norms and eventually to the inalienability of fundamental rights. The intemporality and isolation of such higher norms from mere normative conclusions as any other legal rule would be subject to, has often been a puzzle for law and economics scholarship precisely because of its indiscriminating perspective to the nature of legal norms. A more principled approach to law and economics can help to overcome this shortcoming of the economic analysis of law if further research within this framework are undertake.

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Chapter 13
Homo Economicus, Behavioural Sciences, and Economic Regulation: On the Concept of Man in Internal Market Regulation and its Normative Basis

Jens-Uwe Franck and Kai Purnhagen

Abstract We investigate how EU law conceptualizes the individual to whom internal market regulation is addressed. Our analytical point of departure is a stylized information paradigm, whereby for reasons of internal market benefits, market players have to bear the burden of perceiving and processing information that is relevant in respect of an intended transaction, as well as disadvantages should they be ill-equipped to cope with this assignment. Although the ECJ implemented the normative concept of a well-informed, observant and circumspect consumer, it never adopted such a stylized information paradigm. The EU legislature assists market players in perceiving and processing information, and even seeks to steer their decision-making process. We reconsider whether or to what extent this should be understood as an advancement of an information paradigm or rather as a "behavioural turn". Only a differentiated approach that balances the internal market rationale with potentially conflicting rights meets the exigencies of EU law.

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13.1 Introduction

Despite a considerable broadening of its sphere of activity over the last few decades, the project of creating a well-functioning internal market still remains a central ambition of the European Union.[1] To achieve this objective, the Union regulates in various respects market activities, i.e. it seeks to control, order or influence the economic behaviour of the internal market players[2]: Its institutions pass legal acts. Internal market related law with a regulatory impact is applied by the European Commission as well as by agencies of the Union, and is construed by the European Court of Justice,[3] both of which act in close cooperation with Member State institutions and private players.

Initially referred to in the Lisbon agenda[4] and thereafter emphasized by the white paper on new governance,[5] quality of regulation became a focal point of political and scholarly interest during the last few years.[6] A recent struggle of the European Commission for "better" and "smarter" regulation reflects this development.[7] To improve EU governance as a whole and particularly the quality of regulation, economic analysis has been assigned a key role. Economic implications and consequences of contemplated regulatory acts shall be assessed before any regulatory initiative by the EU.[8] "Better regulation" is expected to achieve an enhancement of allocative and dynamic efficiency, and therefore aims at positive welfare effects.[9]

The normative relevance of the latter point is particularly evident with respect to internal market regulation. As it was already laid down in the *travaux préparatoires* to the Treaty of Rome,[10] the EU law project of an internal market is conceptually

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[1] Article 3(3)1 TFEU.

[2] Cf. the definition of "regulation" adopted by Black, p. 1.

[3] Now officially named "Court of Justice of the European Union", see Section 5, Articles 251 et seq. TFEU. Hereinafter we will refer to it as "the Court" or the "ECJ".

[4] European Council, European Council 23 and 24 March 2000, Lisbon, Presidency Conclusions; Radaelli, 'Regulation', pp. 190 et seqq.

[5] European Governance – A white paper, COM (2001) 428 final; see for an assessment Trubek and Trubek, pp. 539 et seqq.

[6] See Radaelli, 'Measuring', pp. 108 et seqq.

[7] Cf. Alemanno, 'Better Regulation', pp. 382 et seqq.; Allio, pp. 19 et seq.; McColm, pp. 9 et seqq.; Radaelli, 'Regulation', pp. 190 et seqq.; Wiener, pp. 447 et seqq.

[8] Cf. Mandelkern Group on Better Regulation, Final Report, 13 November 2001, p. 34: "Regulation must be viewed as a legal instrument with economic effects carried out through public institutions."

[9] Cf. Mandelkern Group on Better Regulation, Final Report, 13 November 2001, p. 37: "The review of existing regulation should be done [. . .] regarding the effect of existing regulation on innovation, economic growth and employment."

[10] Comité Intergouvernemental Créé Par La Conférence De Messine, Rapport Des Chefs De Délégation Aux Ministres Des Affaires Etrangères, Doc. MAE 120 f/56 (1956), generally referred to as the "Spaak-Report", p. 13: "The object of a European common market should be to create a vast zone of common economic policy, constituting a powerful unit of production and permitting

based on classical free trade theory.[11] First formulated by *Adam Smith* as a theory of absolute advantage, it was *David Ricardo* who subsequently advanced the idea to a theory of comparative advantage[12]: Even if one assumes that a country was more efficient in the production of all goods than another country, both countries would gain by trading with each other, as long as they were characterized by different relative efficiencies. That is because the former country may gain when it specializes in the production of the good where it has a comparative advantage, supposing it may trade that good for other goods whose production it gives up. Thus, by removing obstacles for cross-border trade a greater number of transactions will be made possible, cooperation and specialization based on a division of labour will be facilitated, and competitive pressure will increase. Ideally, this will result in an efficient allocation of production, labour and capital, in cheaper and better products for all market players in the internal market, and ultimately in an enhancement of social welfare.[13]

Consequently, the European legislature is called on to ensure that regulatory initiatives that are based on the competence of the Union to establish an internal market, and particularly on its competence pursuant to Article 114 TFEU, are ultimately apt to indeed reach the efficiency gains that are promised by the project of establishing an internal market.[14] Although efficiency gains do not constitute the only ambition of the internal market, the "efficiency" rationale does in fact form the central means of the day-to-day work of regulators in the EU.[15] Moreover, in construing internal market law, it is up to the ECJ to enforce its economic rationale.[16]

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a continuous expansion, an increased stability, an accelerated raising of the standard of living [...]. To attain these objectives, a fusion of the separate markets is an absolute necessity. Through the increased division of labor, such a fusion will enable the wasting of resources to be eliminated [...]. In an expanding economy, this division of labor is expressed [...] by a relatively more rapid development, in the common interest, of the most economic production programs. Competitive advantage will, moreover, be determined less and less by natural conditions." Translation taken from Ellis, p. 249.

[11] See Irwin on the historical roots of classical free trade theory.

[12] Ricardo, Chapter 7.

[13] See Molle, pp. 35 et seq. and 67.

[14] This is reflected, e.g., in recital (4) Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market, OJ 2007 L319/1: "It is vital, therefore, to establish at Community level a modern and coherent legal framework for payment services [...] which is neutral so as to ensure a level playing field for all payment systems, in order to maintain consumer choice, which should mean a considerable step forward in terms of consumer cost, safety and efficiency, as compared with the present national systems."

[15] The 2007 survey among EU-25 samples of directors of better regulation came to this conclusion, see Claudio Radaelli and Fabrizio de Francesco, *Regulatory Quality in Europe: Concepts, Measures, and Policy Processes*.

[16] See Ari Afilalo, Dennis Patterson and Kai Purnhagen, 'Statecraft, the Market State and the Development of European Legal Culture', for an analysis of the EU's market-related agenda who assign this market-related rationale the feature of a distinct European legal culture.

Therefore, due to both general considerations on "good regulation" and the economic rationale of internal market law, it should be considered unassailable that a state-of-the-art approach to internal market regulation requires consideration of economic theory. However, on this basis internal market law must not only be conceived as having a de-regulatory function having regard to the theory of comparative advantage. Rather, it has to be acknowledged that economic theory has identified categories of so-called market failures that at least in principle may justify (re-)regulation. These categories include in particular monopoly power, externalities, and public goods. To give an obvious example, in contrast to the days of *Adam Smith* and *David Ricardo*,[17] the need for antitrust laws is uncontested today and thus Articles 101 and 102 TFEU form an essential part of internal market regulation.

With respect to our topic, it is important to see that while it has for a long time already been standard knowledge of microeconomic price theory that for markets to function, market players must obtain adequate information on prices and quality of marketed products, it is only since the 1970s that economists have started to focus on information deficits as a potential reason for market failure, and on possible remedies to counter such risks. *George Akerlof* famously described in his seminal paper on "lemon markets" the mechanism whereby informational deficits on the part of consumers due to prohibitively high search costs generate a risk of adverse selection among available products, resulting in a failure of the market to provide high quality goods.[18] It is basically this theory that provides the economic justification to regulate markets if market mechanisms such as signalling through advertisement, labelling and other instruments, reputational mechanisms or information intermediation,[19] do not suffice to provide for an adequate level of product-related information, or where market players are rationally ignorant of available information due to prohibitively high costs or cognitively inapt to perceive and process available information. There is a broad range of potential regulatory remedies available to regulators, reaching from measures to prevent deceptive practices, through mandatory information duties to content-related regulation such as, for example, a definition of mandatory quality standards.[20]

Yet as such (re-)regulatory measures whose justification lies in potential informational deficits may themselves establish a restriction on free trade and which, therefore, are subject to legal scrutiny, the question has to be raised as to what kind of individual behaviour should be assumed in this regard. Neoclassical microeconomic

[17] See Smith, p. 160: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice."

[18] Akerlof, pp. 488 et seqq.; previously, Chamberlin, pp. 24–27, had already described the risk of adverse selection due to consumers' ignorance of product quality.

[19] See for an overview on market mechanisms that may counter informational deficits Franck, *Absatzrecht*, pp. 190–203.

[20] See for an overview Franck, *Absatzrecht*, pp. 203–216.

theory assumes a rational human being to whom stable preferences, self-serving, and transitive behaviour are attributed,[21] a model man that is conventionally labelled *homo economicus*.[22] Yet insights of different sciences whose interests are dedicated to human behaviour like cognitive psychology and behavioural economics have revealed various phenomena of cognitive deficits and bounded rationality that are in particular of relevance with regard to perceiving and processing information and decision behaviour.[23] This has triggered an intra-economic debate on whether it may be feasible or even imperative to integrate such findings into general micro-economic theory. Among economists scepticism seems to be widespread in this regard as they tend to stress an inherent tendency of markets to reward rational behaviour while they punish irrationality. Thus, it is assumed that those market players who do behave rationally will have a decisive influence on prices, quantity, and quality of products and other market parameters.[24] Among lawyers and scientists from related disciplines, the debate about whether and to what extend findings of behaviour sciences may influence regulation is also in full swing. Positions as to a need for their implementation into regulatory strategies range from outright rejection[25] to limited[26] or at least careful[27] and full support.[28]

Viewed from the position of a regulator who seeks to employ economic expertise, such intra-economic controversies and their spill-over to other disciplines must not be ignored. Yet since regulation happens within a legal framework, the issue of an individual behaviour model has a normative dimension, too. Thus, it may not be regarded as a merely technical aspect of behavioural sciences. It is based on this insight and against the background of the important role attributed particularly to information economics with respect to internal market regulation that we investigate how positive EU law conceptualizes the individual to whom internal market regulation is addressed.

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[21] The first formulation of the rationale behind the concept of a homo economicus is attributed to Mill, Essay 5, paras. 38 and 48.

[22] Mathis, pp. 7–30.

[23] Early works include Kunreuther and Slovic, pp. 64 et seqq.; Kahneman and Tversky, pp. 263–291; Robin Hogarth, *Judgment and Choice, The Psychology of Decision*; Daniel Kahneman, Paul Slovic and Amos Tversky, *Judgment under Uncertainty: Heuristics and Biases*. An illustrative survey of various insights presents Eisenberg, pp. 216–218. A popular science presentation has been produced by Richard H. Thaler and Cass Sunstein, *Nudge, Improving Decisions About Health, Wealth, and Happiness*.

[24] Varian, Chapter 30.5, pp. 560 et seq. This point has also been stressed by law-and-economics scholars such as Schwartz, pp. 131 et seqq. and Posner, pp. 1551 et seqq.

[25] Pardo and Patterson, pp. 1211 et seqq.

[26] Bottalico, pp. 427 et seqq.; Frerichs, pp. 289 et seqq.

[27] Selinger and Whyte, pp. 26 et seqq.

[28] Alemanno, 'Nudging Smokers', pp. 32 et seqq.; Burgess, pp. 3 et seqq.; Amir and Lobel, pp. 17 et seqq.; Sunstein, 'Humanizing', pp. 3 et seqq.

13.2 The Establishment of the Concept of a Well-Informed, Observant and Circumspect Internal Market Player and its Normative Justification

The idea that information rules might operate less restrictively (but potentially adequately effectively) compared to mandatory content-related regulation, and particularly if compared with product bans, is an assumption that has been considered in the context of European securities markets regulation already in the 1960s.[29] This rationale that was later conceptualized as the "information model" of internal market law[30] gained general importance in the aftermath of the ECJ's seminal judgment "Cassis de Dijon". In this case, Germany had prohibited the distribution of a French brand of liquor since the marketing of fruit liqueurs was subject to the condition of a minimum alcohol content of 25 %. The ECJ, interpreting the notion of measures having equivalent effect to quantitative import restrictions as it is now laid down in Article 34 TFEU, put forward the argument that the restrictive effect of trade that goes along with such a mandatory requirement may not be justified if the protective purpose pursued could be adequately served by providing information to consumers:

> As the Commission rightly observed, the fixing of limits in relation to the alcohol content of beverages may lead to the standardization of products placed on the market and of their designations, in the interests of a greater transparency of commercial transactions and offers for sale to the public.
>
> However, this line of argument cannot be taken so far as to regard the mandatory fixing of minimum alcohol contents as being an essential guarantee of the fairness of commercial transactions, since it is a simple matter to ensure that suitable information is conveyed to the purchaser by requiring the display of an indication of origin and of the alcohol content on the packaging of products.[31]

Two notions are enshrined in this passage that became essential features of the conceptual debate on the regulatory framework for the internal market. This is, first, a dichotomy of "information-related" vs. "content-related" rules[32] in conjunction

[29] Cf. the so-called "Segré-Report", European Economic Community, The Development of a European Capital Market, Report of a Group of experts appointed by the EEC Commission (1966), pp. 225–238; see Ackermann, p. 237.

[30] Steindorff, p. 195.

[31] ECJ, 20 February 1979, Case 120/78, *REWE v Bundesmonopolverwaltung für Branntwein*, [1979] ECR 649, para. 13.

[32] In fact, the rule of German law in question could be characterized as "information-related" as it was apparently only prohibited to market the product under the label "Cassis" or "fruit liqueur". Viewed in this light, the judgment might be interpreted as dismissing one information-related regime as unnecessarily intrusive given the existence of a less intrusive but equally effective information based rule. However, in its later case-law the Court considered a domestic prohibition of certain publicity markings that were born by a product as an obstacle to intra-Community trade by nature as opposed to mere selling arrangements. The Court based this finding on the fact that such rules "may compel the importer to adjust the presentation of his products according to the place where they are to be marketed and consequently to incur additional packaging and advertising

with the statement that when a problem has been identified as requiring a regulating measure (i.e., it is assumed that market mechanisms alone are insufficient to ensure the necessary degree of consumer protection, fairness of competition etc.), preference should be given to an information-related rule wherever that seems sufficient to cure the problem.[33]

Yet it is essentially the yardstick that is applied to evaluate which regulating means are considered sufficient and necessary to reach a legitimate protective objective that ultimately decides on how effective this standard really is in respect of its liberalizing, market-opening ratio. In this regard, the second noteworthy point of the passage quoted from the judgment in "Cassis de Dijon" comes into play, as the ECJ without much ado presumed with regard to the case at hand that the consumers' interests in purchasing products that would correspond to their preferences would be adequately served by indicating the alcohol content on a tag.

Thus, on the one hand the Court assumed on the part of the producer a duty to provide product related information and therefore implicitly acknowledged a justification for (re-)regulation to ensure that adequate information is provided on the market. In the context of "Cassis de Dijon", this certainly does not seem to be a contentious step as a producer may generally be regarded as being in the position to generate such product related information in the most efficient way. On the other hand and more remarkably, the ECJ shifted the burden of perceiving and processing information to some extent to the consumers. That is because it would save them the time and the trouble to read the small print on a tag if the use of a certain label like "fruit liqueur" already indicated a certain (minimum) alcohol content. The ECJ's judgment implicitly involved a trade-off: in order to benefit from lower barriers for internal market trade that may entail enhanced competition, lower prices and a broader choice of products, one should risk the consequence that a certain number of consumers will suffer a disadvantage, namely those who are not able or willing to carry the increased burden of information perceiving and processing, and who would for example purchase a bottle of "Cassis de Dijon" only to realize later that due to the insufficient alcohol content another product would have better served their preferences. The Court expects a learning process on the part of these consumers, in the course of which they may suffer a material disadvantage.

In its subsequent case-law, the ECJ more explicitly elaborated on its concept of the consumer as an internal market player. In particular, the ECJ had various occasions to judge on the question whether certain labels, material or techniques used for commercial communication could be regarded as deceptive and therefore, legitimately prohibited by domestic law. In this context, the Court held that the deceptive potential of commercial communication must be assessed taking

costs", ECJ, 6 July 1995, Case C-470/93, *Verein gegen Unwesen in Handel und Gewerbe Köln v Mars*, [1995] ECR I-1936, para. 13. Against the background of this reasoning, it seems consequent to characterize a rule according to which a certain label may only be used for products that fulfill specified content-requirements as "content-related" and not as merely "information-related".

[33] See Usher, pp. 152 et seq.

the viewpoint of the "average consumer who is reasonably well-informed and reasonably observant and circumspect".[34]

While the ECJ originally developed this concept as an expression of the principle of proportionality with regard to the interpretation of the free movement of goods (Article 34 TFEU) and therefore as a standard of Union law confining domestic law that establishes obstacles to free trade, subsequently the Court applied the same yardstick to construe which practices may be considered "deceptive" under secondary law that aimed at harmonizing domestic protective standards in order to ensure free trade in the internal market.[35] This spill-over of the consumer concept from the interpretation of a fundamental freedom to legislative internal market activities of the Union, that is, from the de-regulatory to the re-regulatory aspect of internal market law, is consequent first, since the secondary internal market legislation follows in principle the same rationale and secondly, because it has to be regarded as settled law that not just the national legislatures but also the institutions of the Union are bound by the fundamental freedoms.[36]

It is against the background of this case-law that authors such as *Steindorff,*[37] *Weatherill,*[38] and *Wilhelmsson*[39] posited in the context of the internal market the concept of a confident consumer as an antithesis to the concept of a weak and vulnerable consumer, and *Steindorff* developed what has later been labelled the "information paradigm" of internal market law.[40] According to this notion, as the internal market is characterized by differentiated and fragmented conditions, it might only operate effectively to the benefit of all market players and to the society as a whole if the consumers who were on the one hand enriched with a wider choice of products had, on the other hand, to bear the burden of perceiving and processing information which were relevant to decide which product actually could meet their

[34]The ECJ has consistently used this wording since its judgment of 16 July 1998, Case C-210/96, *Gut Springenheide and Tusky v Oberkreisdirektion Steinfurt*, [1998] ECR I-4657, para. 37. Prior to this decision the Court had already referred to the "[r]easonably circumspect consumer" as yardstick, ECJ, 6 July 1995, Case C-470/93, *Verein gegen Unwesen in Handel und Gewerbe Köln v Mars*, [1995] ECR, I-1923, para. 13: "Reasonably circumspect consumers may be deemed to know that there is not necessarily a link between the size of publicity markings relating to an increase in a product's quantity and the size of that increase."

[35]ECJ, 2 February 1994, Case C-315/92, *Verband Sozialer Wettbewerb v Clinique Laboratories and Estée Lauder*, [1994] ECR I-317, para. 16; ECJ, 28 January 1999, Case C-77/97, *Österreichische Unilever v Smithkline Beecham Markenartikel*, [1999] ECR I-431 para. 27; ECJ, 24 October 2002, Case C-99/01, *Linhart and Biffl*, [2002] ECR I-9375, para. 26.

[36]ECJ, 9 August 1994, Case C-51/93, *Meyhui v Schott Zwiesel Glaswerke*, [1994] ECR I-3879, para. 11.

[37]Steindorff, pp. 195 et seq.

[38]See Weatherill, 'Evolution', pp. 423 et seqq.

[39]Wilhelmsson, *Contract Law*, pp. 145 et seq.

[40]The notion of an "information model" in the internal market context has subsequently been taken up by several authors, see *inter alia* the articles in Stefan Grundmann, Wolfgang Kerber and Stephen Weatherill, *Party Autonomy and the Role of Information in the Internal Market*.

preferences. That is, in the internal market context, consumer protection and unfair competition law had to be interpreted instrumentally and hence, reconciled with the normative objectives to foster free trade and the integration of the national markets. Thus, protection against deceptive practices, for instance, must not take the ignorant consumer as a yardstick since such an approach would ultimately require the prescription of uniform products.[41] By and large it shall be considered sufficient to ensure for reasons of consumer protection a free access to information which might be relevant for a rational transaction decision.

To argue along the lines of an information paradigm in a pure form would imply a model of a "smart and decent" internal market player who did not suffer from capacity constraints or mental defects or biases in perceiving and processing data, and who realized market transactions based on available information, rationally balancing pros and cons and being aware of their own preferences.[42] It is precisely such an ideal of an internal market player that shares essential features with the concept of a *homo economicus*, and which presupposes a rational and self-interested actor who has the ability to make judgments towards their subjectively defined ends.

Though the early protagonists of an information paradigm for internal market regulation could not yet appreciate the insights of cognitive psychology, behavioural economics or other disciplines on characteristics of human behaviour, as they were taken up only during the last decade or so by legal writers, they were certainly not naïve as to the realities of consumers', investors' or other market players' individual capacity to process information and to reach rational decisions on that basis. *Steindorff*, for instance, made it clear that his concept had to be understood as a normative one when he wrote that the internal market "demanded" a circumspect consumer. It is for the sake of internal market integration that market players should bear the burden of perceiving and processing information, and also the drawbacks that may follow should they carry out a market transaction suffering a cognitive deficit.[43]

The ECJ's concept of a "reasonably well-informed and reasonably observant and circumspect" consumer has to be regarded as a normative one, too. This insight is supported by the fact that the ECJ on various occasions denied the deceptive potential of a commercial communication without considering its actual perception by the addressees in question.[44] This has led to the persistent conclusion among

[41] AG Capotorti, 16 January 1979, Case 120/78, *Rewe v Bundesmonopolverwaltung für Branntwein*, [1979] ECR 666, 673: "But the idea of this widespread, if not general, incapacity on the part of the consumer seems to me to doom to failure any effort to protect him, unless it be to impose upon him a single national product the composition of which is constant and is rigorously controlled."

[42] Cf. Wilhelmsson, *Contract Law*, pp. 145 et seq.: "[. . .] one can claim that the consumer model prevailing in the Community is a well-informed and well-to-be-informed consumer – the active internal market consumer – who can and should decide on his own affairs and at his own risk."

[43] Steindorff, pp. 195 et seq.

[44] ECJ, 13 December 1990, Case C-238/89, *Pall*, [1990] ECR I-4827, paras. 18–21; ECJ, 2 February 1994, Case C-315/92, *Verband Sozialer Wettbewerb v Clinique Laboratories and Estée*

some scholars according to which consumer protection in the EU was categorical in the sense that "[w]hoever falls under the definition is entitled to protection, and to the same degree".[45]

A closer look at EU consumer law in action discloses quite the contrary:[46] It is essential to see that the ECJ in its interpretation of prohibitions of deceptive practices did not adopt an information paradigm in a pure sense, shifting the burden of perceiving and processing information generally and entirely onto the individual market player. This is in particular reflected by the use of the attribute "reasonably" in the aforementioned phrase, which leaves the door open to a differentiated yardstick. Thus, it has been recognized by the ECJ that the level of attention (normatively) expected from a consumer may "vary according to the category of goods or services in question".[47] Moreover, the Court submitted that its concept of a "reasonably well-informed and reasonably observant and circumspect" consumer would not apply in contexts where a "mistake as to the product's characteristics [may] pose any risk to public health".[48] That is, in defining whether a piece of commercial communication has to be considered deceptive, the Court takes into account normative considerations such as "public health" which may conflict with an internal market rationale.

13.3 The Information Paradigm and the Individual Cognitive and Behaviour Concept Behind (Secondary) Internal Market Law

13.3.1 The Internal Market Rationale Pro-Choice: Harmonization of Information-Related Regulation May Supersede Harmonization of Product Standards

The message delivered by the ECJ in "Cassis de Dijon" according to which a wide choice of products should be available to the benefit of all internal market players, and hence, protective purposes like consumer protection, fairness of competition etc. should as far as possible be addressed by information-related rules rather than by

Lauder, [1994] ECR I-317, paras. 19–23; ECJ, 4 April 2000, Case C-465/98, *Darbo*, [2000] ECR I-3397, paras. 21–34; ECJ, 24 October 2002, Case C-99/01, *Linhart and Biffl*, [2002] ECR I-9375, paras. 31–35.

[45] Hesselink, p. 327.

[46] See in general on European consumer law Weatherill, 'Consumer Protection', pp. 221 et seqq.

[47] Cf. ECJ, 22 June 1999, Case C-342/97, *Lloyd Schuhfabrik Meyer v Klijsen Handel*, [1999] ECR I-3819, para. 26.

[48] ECJ, 13 January 2000, Case C-220/98, *Estée Lauder*, [2000] ECR I-117, para. 28; see also ECJ, 24 October 2002, Case C-99/01, *Linhart and Biffl*, [2002] ECR I-9375, para. 31.

content-related rules, affected also the focus of secondary internal market regulation. It encouraged the internal market legislature to seek to foster free product trade based on a harmonization of information-related rules, largely waiving ambitions to harmonize product specifications.[49] Therefore, it does not come as a surprise that a large bulk of secondary internal market law may be characterized as information-related: mandatory information requirements for producers and dealers, regulation of various instruments of commercial communication (advertisement, labelling, and brochures), withdrawal rights as well as rules on information intermediaries such as insurance agents and brokers. To this end, for example recital (21) of Directive 2003/71/EC (Prospectus Directive)[50] stipulates that "[i]nformation is a key factor in investor protection". Recital (18) of the Prospectus Directive becomes even more concrete:

> The provision of full information concerning securities and issuers of those securities promotes, together with rules on the conduct of business, the protection of investors.

It is in accord with the internal market rationale that such information-related regulation may to a large degree supersede content-related regulation as a mechanism to protect the interests of consumers, investors and other market players. That is, the internal market legislature has taken up the ECJ's reasoning in "Cassis de Dijon" whereby the Court indicated its acceptance to some extent of a lower level of consumer protection in order to harvest the benefits of an enlarged market with lower barriers to free trade, enhanced competition and a wider choice of available products. This "trade-off" rationale is partly reflected in the reasoning for secondary internal market legislation, though expressed in a euphemistic way, such as in recital (52) Life Insurance Directive[51] which stipulates:

> [I]n an internal market for assurance the consumer will have a wider and more varied choice of contracts. If he/she is to profit fully from this diversity and from increased competition, he/she must be provided with whatever information is necessary to enable him/her to choose the contract best suited to his/her needs.

Hence, seen against the background of the dichotomy of "information-related" vs. "content-related" rules, it is correct to state that secondary internal market law is dominated by an "information paradigm", as indeed a large part of market-related rules aims at ensuring that a sufficient degree of (correct) product information is provided on the market, assuming that market mechanisms alone are insufficient to ensure an efficient generation of transaction relevant information. Certainly, a considerable number of content-related internal market rules exist nevertheless, which

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[49] See Grundmann, Kerber and Weatherill, *Party Autonomy*, p. 7.

[50] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public and admitted to trading, OJ 2003 L 345/64.

[51] Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance, OJ 2002 L 345/1.

are either designed as direct top-down regulation, such as the prohibition of certain chemical substances in Article 56 Regulation (EC) No 1907/2006 (hereinafter REACH),[52] or incentives-regulation such as in the "new approach" Directives.[53] However, conceptually this regulatory approach represents an exception that is mainly reduced to the role of a protective mechanism where crucial individual rights such as the individual health of a market player is at stake but not if the regulated market behaviour may affect merely financial interests. That is the reason why, for example, Article 3 Tobacco Products Directive[54] stipulates maximum tar, nicotine, and carbon monoxide yields.

The general internal market rationale "permit but inform" in favour of enhanced competition and a wide product choice, as it is also reflected in secondary legislation, entails the basic normative assumption that market players are smart enough to cope with a large diversity of products given that the regulator ensures through various information-related instruments that sufficient information is available on the market that enables them to make transactions that meet their preferences. Yet it is important to see with regard to the individual cognitive and behaviour concept behind such an information-focused regulatory strategy that a general orientation in favour of pro-choice neither presumes a decision whereby the burden of perceiving and processing information is entirely left on the individual market player, nor that the legislator had to abstain from any attempt to steer transaction decisions in certain directions.

We will show that a stylized information paradigm according to which the internal market player has to carry the full burden of information processing has actually never been realized in internal market law. Rather, the selection and weighting of information by the legislator and its choice on how it has to be made accessible to the market players has always taken a certain part of the burden of information processing from the individual market player. As the following paragraphs reveal, the internal market legislator is first of all indeed sensitive to the needs of market players who are particularly vulnerable. Secondly, it seeks in many respects to facilitate information processing on the part of the market players. Thirdly, it strives to influence market players' decision-reaching, partly even strategically following a certain political agenda.

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[52]Regulation (EC) No 1907/2006 of the European Parliament and of the Council of 18 December 2006 concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) and establishing a European Chemicals Agency, OJ 2006, L 136/3.

[53]The standard example is Directive 2001/104/EC of the European Parliament and of the Council of 7 December 2001 concerning medical devices, OJ 2002, L 6/50. See on the EU's new approach regulation Hodges, pp. 22 et seqq. where a list of new approach legislation is provided.

[54]Directive 2001/37/EC of the European Parliament and of the Council of 5 June 2001 on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco products, OJ 2001 L 194/26.

13.3.2 Acknowledging Individual Weaknesses: Protecting Particularly Vulnerable Market Players

Granting specific protection to market players who are particularly vulnerable has been accepted by the ECJ as a legitimate restriction on trade. In "Buet" the ECJ accepted a French ban on canvassing for the purpose of selling educational material:

> [T]he potential purchaser often belongs to a category of people who, for one reason or another, are behind with their education and are seeking to catch up. That makes them particularly vulnerable when faced with salesmen of educational material who attempt to persuade them that if they use that material they will have better employment prospects.[55]

The Court considered a prohibition on direct marketing a proportionate protective mechanism since "an ill-considered purchase could cause the purchaser harm other than mere financial loss that could be longer lasting".[56] Though it remains an exception to the general consumer concept in internal market context,[57] there are various examples in secondary internal market regulation, too, which illustrate that consideration has been given to the needs of particularly vulnerable market players. This demonstrates that in such contexts neither the ECJ nor the internal market legislator expects a learning process on the part of these individuals that may entail disadvantages for them.

Particularly Vulnerable Consumers

As a cornerstone of secondary internal market law, the Unfair Commercial Practices Directive[58] establishes uniform rules on commercial communication and marketing activities at the Union level, thereby, creating a level playing field for businesses, and facilitating them in exercising their internal market freedoms. The regulatory approach that has been implemented through the Directive may be characterized by three elements: market transparency, freedom of choice, and freedom of decision-making for consumers.[59] Pursuant to Article 5(2)(b) of the Directive, a commercial practice shall be unfair if "it materially distorts [...] the economic behaviour with regard to the product of the average consumer whom it reaches or to whom it is addressed [...]".

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[55] ECJ, 16 May 1989, Case 382/87, *Buet and another v Ministère public*, [1989] ECR 1235, para. 13.

[56] Id., para. 14.

[57] See Howells and Wilhelmsson, p. 381 ("The protection of the weak and vulnerable consumers has probably never been very high on the agenda of Community law").

[58] Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council ("Unfair Commercial Practices Directive"), OJ L 149/22, 2005.

[59] Cf. Micklitz, p. 71.

As explained in recital (18), this has to be understood as a reference to the concept of the "reasonably well-informed and reasonably observant and circumspect" consumer as it was shaped in the ECJ's jurisprudence.[60]

Yet Article 5(3) of the Directive requires a special protection of consumers "who are particularly vulnerable to a commercial practice or the underlying product because of their mental or physical infirmity, age or credulity" as the unfairness of the commercial practice in question "shall be assessed from the perspective of the average member of that group". However, this stricter yardstick applies only if a commercial practice is "likely to materially distort the economic behaviour only of a clearly identifiable group of consumers".

Therefore, it is restricted to instances where the practice is particularly addressed at such a group, for example if its presentation is especially appealing to children.[61] Moreover, the exceptional character of this provision is further emphasized through the restrictive indication whereby "[t]his is without prejudice to the common and legitimate advertising practice of making exaggerated statements or statements which are not meant to be taken literally".

In the same vein, recital (34) of the Directive on Consumer Rights[62] requires traders to "take into account the specific needs of consumers who are particularly vulnerable" when providing information. Recital (34) then further defines these groups as "consumers who are particularly vulnerable because of their mental, physical or psychological infirmity, age or credulity".

Minors

In order to protect minors,[63] Article 9(1)(e) Audiovisual Media Services Directive[64] prohibits commercial communication for alcoholic beverages that is aimed specifically at minors. Moreover, Article 9(1)(g) of the Directive stipulates that "commercial communications shall not cause physical or moral detriment to minors", and therefore "they shall not directly exhort minors to buy or hire a product

[60] Recital (18): "In line with the principle of proportionality, and to permit the effective application of the protections contained in it, this Directive takes as a benchmark the average consumer, who is reasonably well-informed and reasonably observant and circumspect [. . .] as interpreted by the Court of Justice [. . .]."

[61] There is no need to say that it is far from obvious where one should draw the line in those cases, cf. Micklitz, p. 88.

[62] Directive 2011/83/EU of the European Parliament and of the Council of 25 October 2011 on consumer rights, amending Council Directive 93/13/EEC and Directive 1999/44/EC of the European Parliament and of the Council and repealing Council Directive 85/577/EEC and Directive 97/7/EC of the European Parliament and of the Council, OJ L 304/64, 2011.

[63] See on the need of the protection of minors in their role as consumers Pessers, pp. 2 et seqq.

[64] Directive 2010/13/EU of the European Parliament and of the Council of 10 March 2010 on the coordination of certain provisions laid down by law, regulation or administrative action in Member States concerning the provision of audiovisual media services, OJ 2010 L 95/1.

or service by exploiting their inexperience or credulity, directly encourage them to persuade their parents or others to purchase the goods or services being advertised, exploit the special trust minors place in parents, teachers or other persons, or unreasonably show minors in dangerous situations".

Sick Persons

People who are suffering from a disease are considered particularly susceptible to alluring advertisement messages, and might tend to make spontaneous decisions that actually contradict their own preferences. To work against such risks, various rules restrict commercial communication that attributes to food the property of preventing, treating or curing a human disease,[65] and even prohibit commercial communication for medicinal products and medical treatment available only on prescription.[66]

13.3.3 Recognizing Individual Cognitive Constraints: Regulative Activities to Facilitate Information Processing

Internal market regulation makes ample use of regulatory techniques that have as their object and effect to facilitate market players in perceiving and processing information. It is the basic concept of these rules to reduce effort and costs that have to be borne by a market player who seeks to make a rational, information-based transaction decision. This finding indicates that the internal market legislature does indeed take into account individual cognitive constraints and deficits in this respect, and does not just rely on market mechanisms to overcome these problems.

Rules on the Way Information Has to Be Presented

There is a multitude of rules requiring that information is provided in a transparent way. To take an example from labelling law, Article 6(1) Cosmetic Products Directive[67] provides that information on the container and on the packaging is given

[65] See e.g. Article 6(2) Directive 2002/46/EC of the European Parliament and of the Council of 10 June 2002 on the approximation of the laws of the Member States relating to food supplements, OJ 2002 L 183/51; Article 8 Directive 2009/39/EC of the European Parliament and of the Council of 6 May 2009 on foodstuffs intended for particular nutritional uses (recast), OJ 2009 L 124/21.

[66] Article 9(1)(f) Audiovisual Media Services Directive.

[67] Council Directive 76/768/EEC of 27 July 1976 on the approximation of the laws of the Member States relating to cosmetic products, OJ 1976 L 262/169.

"in indelible, easily legible and visible lettering". An investment company has to include in its prospectus an explanation of the fund's risk profile which is "clear and easily understandable".[68] Pursuant to Article 10(1) Directive on electronic commerce[69] mandatory information has to be provided "clearly, comprehensibly and unambiguously".

The language of provided information is an essential factor of how much effort a market player has to put into perceiving information. Various language-related rules ensure that provided information is accessible to the addressee. For example, it is required according to Article 4(3) Timeshare Directive[70] that owed information "is drawn up in the language [. . .] of the Member State in which the consumer is resident or a national, at the choice of the consumer, provided it is an official language of the Community".

Standardization makes it easier for market players to compare prices and other product-related information. Exemplary in this respect is the requirement that traders have to indicate not only the selling price but also the price per unit of measurement.[71] To pick up another example, the mandatory nutrition declaration has to include information on the energy value that shall be expressed per 100 g or per 100 ml.[72]

Weighting of information signals which pieces of information are presumably the most relevant, and thus may facilitate a rational application of the limited resources of market players to perceive and process information in preparation of a transaction decision. A requirement of a specific sequential arrangement of data, for instance, entails a formal weighting of the provided information. Article 6(1)(g) Cosmetic Products Directive, for example, requires that the packaging includes "a list of ingredients in descending order of weight". A substantive form of weighting comes along with an outspoken classification of information, for instance if certain information has to be characterized as an "Important Notice", e.g. in accordance with Article 13(4) Infant Formulae Directive,[73] or even as a

[68] Article 69(1) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast), OJ 2009 L 302/32.

[69] Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market, OJ 2000 L 178/1.

[70] Directive 2008/122/EC of the European Parliament and of the Council of 14 January 2009 on the protection of consumers in respect of certain aspects of timeshare, long-term holiday product, resale and exchange contracts, OJ 2009 L 33/10.

[71] Article 3 Directive 98/6/EC of the European Parliament and of the Council of 16 February 1998 on consumer protection in the indication of the prices of products offered to consumers, OJ 1998 L 80/27.

[72] Article 32(2) Regulation (EU) No 1169/2011 of the European Parliament and of the Council of 25 October 2011 on the provision of food information to consumers, OJ 2011 L 304/18.

[73] Commission Directive 2006/141/EC of 22 December 2006 on infant formulae and follow-on formulae and amending Directive 1999/21/EC, OJ 2006 L 401/1.

"warning", e.g. pursuant to Article 6(3)(c) Food Supplements Directive[74] or Article 19(5) Markets in Financial Instruments Directive.[75]

Regulation of Information Intermediaries

Internal market law includes detailed rules on insurance mediation[76] and investment firms[77] by means of which the legislature attributes to insurance and investment agents and brokers the function to serve as information intermediaries.[78] The need for regulation in these fields rests upon the assumption that first, the individual customer or investor is unable to cope with the amounts of information that has to be provided to the markets by insurance companies, issuers of securities, investment companies etc. and secondly, that market mechanisms including mechanisms of information intermediation are not sufficient to make up for these deficits. Both assumptions are well-founded.[79]

It should be pointed out that the establishment of single European insurance and investment markets had a strong liberalizing and deregulating impact. As a consequence, the range of available financial instruments – that due to their character as complex experience or credence goods, respectively,[80] entail high information asymmetries and search costs anyway – has significantly widened. Internal market regulation to strengthen the role of information intermediaries has to be understood against this background,[81] and fits into an internal market rationale which on the one hand accepts a trade-off between higher financial risks on the part of consumers and investors caused by increasing information problems and positive welfare effects through an enlarged market, but on the other hand seeks by way of

[74] Directive 2002/46/EC of the European Parliament and of the Council of 10 June 2002 on the approximation of the laws on the Member States relating to food supplements, OJ 2002 L 183/51.

[75] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments, OJ 2004, L 145/1.

[76] Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation, OJ 2003 L 9/3.

[77] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments, OJ 2004, L 145/1.

[78] Franck, *Absatzrecht*, pp. 305–319.

[79] See e.g. the law-and-economics analysis by Grundmann and Kerber, pp. 264 et seqq.

[80] The term "experience good" has been established by Nelson, pp. 311 et seqq., to characterize products whose quality can hardly be observed in advance but only upon consumption. Darby and Karni, pp. 68 et seq., introduced the concept of "credence goods" for goods whose quality consumers may not judge even after they consumed them.

[81] Cf. recital (2) Markets in Financial Instruments Directive: "In recent years more investors have become active in the financial markets and are offered an even more complex wide-ranging set of services and instruments."

various regulative mechanisms to counter these risks of information deficits, though as far as possible without restricting the choice of products generated by the internal market in the first place.

Steering the Process of Decision-Making: Explicit and Implicit Paternalism

Where a regulator does not only assist market players in ensuring the informational basis to find an informed transaction decision, but where it also seeks to influence the content of that decision in their best interest, such a regulatory impact may be considered "paternalistic". The finding of phenomena of bounded rationality through the behavioural sciences seems to have opened up a leeway for regulators to engage in what has been dubbed "libertarian paternalism".[82] Thus, steering the individual process of decision making in a certain direction might be regarded as legitimate on the grounds that individual market players have to be assisted in reaching a decision that meets their preferences or that they have to be prevented from acting irrationally against their own best interest, respectively.

This line of argument may be employed on the one hand to give reason to content-related regulation, e.g. to justify a prohibition of potentially dangerous products. On the other hand, it may also substantiate regulatory techniques that, while they influence the decision-making process of market players in a certain direction, e.g. through the selection or the way of presentation of information that has to be provided to them, technically preserve an individually free product choice and which therefore have to be considered to be less intrusive than a content-related regulation. As may be demonstrated by the following examples taken from internal market regulation, the manipulative and thus paternalistic facet of such regulatory interventions may be more or less pronounced.

Warnings Against Tobacco Products

Article 5 Tobacco Products Directive requires that both a general and an additional warning against the damaging effects of smoking are printed on each unit packet of tobacco products and that these warnings have to cover not less than 30 % and 40 %, respectively, of the external area of the surface of the packet. The language of these warnings is at least in part highly suggestive ("Smoking can cause a slow and painful death"[83]). Member states may require additional warnings in the form of colour photographs and other illustrations. These may be chosen from a library of 42 pictorial health warnings designed by the Commission. Several of these images appear to be quite shocking to an observer.[84]

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[82] Cf. Sunstein and Thaler, pp. 1159 et seqq.

[83] Annex I no. 9 Tobacco Products Directive.

[84] See http://ec.europa.eu/health/tobacco/law/pictorial/index_en.htm.

The way the information on the health risks of smoking has to be presented to potential purchasers illustrates that the objective of this regulative measure goes beyond enabling consumers to make an informed transaction decision. Rather, it is the obvious agenda to prevent them from purchasing a – perfectly legal – product. Tobacco regulation aims at affecting social habits, even if regulation comes in the guise of information.[85] Pursuant to its legitimizing assumption, people who smoke do so contrary to their own preferences. This implies that if only they had sufficient inner strength they would certainly keep their hands off tobacco products. Thus, tobacco regulation conceptualizes the consumer as a person who even if informed about the health risks of a product is not able to act according to their own best interest.

Notice in Favour of Breast Feeding

Article 13 Directive 2006/141/EC[86] permits the marketing of infant formulae only if its label contains *inter alia* "a statement to the effect that the product is suitable for particular nutritional use by infants from birth when they are not breast fed", and if the labelling bears under the headline "Important Notice" a statement concerning the superiority of breast feeding. On the one hand, such a notice informs addressees about the suitability of feeding infants with the respective product but that breast-feeding is in general considered to be a preferable way of feeding them. On the other hand, such a requirement aims not only at enabling consumers to make an informed decision. The statement contains a judgment, and the obvious purpose is to bring mothers of infants to consider the purchase of the product only as a second class option. Though the promotion of breast feeding might be fairly uncontroversial,[87] the example demonstrates that a requirement to provide a certain piece of information necessarily entails a paternalistic facet that becomes particularly apparent where the information in question has to be particularly emphasized and where it not only concerns product related data, but also normative statements.

Formal Weighting of Required Information

To require a weighting of information according to a formal and therefore, apparently neutral criterion such as, for example, the aforementioned listing of "ingredients in descending order of weight" pursuant to Article 6(1)(g) Cosmetic Products Directive, is not entirely free of a paternalistic element: As higher-ranked

[85] See Alemanno, 'Nudging Smokers', pp. 32 et seqq.

[86] Commission Directive 2006/141/EC of 22 December 2006 on infant formulae and follow-on formulae and amending Directive 1999/21/EC, OJ 2006 L 401/1.

[87] But see on potential negative effects of breastfeeding promotion Lee, pp. 1075 et seqq.

pieces of information are more likely to be perceived by consumers, the rule may provoke a situation where ingredients with a higher weighting may be more influential on the decision to purchase the product in question.

Though this effect might be fairly weak, it shows that there is no such thing as a purely neutral, absolutely non-paternalistic way to select and present information. Every regulatory choice as to which information has to be provided and how it has to be provided is necessarily accompanied by an element of paternalism, if only as a matter of fact, as the regulatory decision may not be based on a determined agenda to steer decision-making of information addressees in a certain direction.

Defining a Required Method of Access to Information

As may be illustrated using the example of information distribution in respect of chemical substances, the prescribed path by which a piece of information has to be disseminated carries some potential to steer behaviour more or less effectively in a certain direction. Any chemical substance within the scope of REACH and beyond the amount of 1t requires labelling in accordance with Articles 5, 6, 10(a)(iv), Section 4 of Annex VI REACH, Regulation 1272/2008 (CLP-Regulation) in order to be fit for marketing. Articles 77(2)(e) and 119 REACH stipulate the availability of these labels on the internet. The labelling requirements shall enable the addressee to evaluate directly the dangers involved in the use of the substance. Additionally, according to the principle of substitution, it shall enable the addressee to assess which substance could be used that results in less harm but has the same effect. In other words: It shall enable the users at the moment they intend to use the substance to assess how to handle it safely.

However, if the very same substance is (only) part of an article, is not intended to be released, and the European Chemical Agency did not request special labelling according to Article 7(5) REACH, pursuant to Article 33 REACH the information on how to handle the risks involved with the substance must be made available only on the special request of the consumer. The same information aimed at the safe use of a substance is therefore directly available in the case that the addressee is directly exposed to the substance, whereas when the same substance is contained in an article, the information is regularly only available on the request of the consumer.

Obviously, users of a substance may much more easily observe a warning that is issued on the container of a substance than if they have actively to ask for it. It follows that the EU lawmaker refrains from imposing the burden to access information on users that are directly exposed to a substance. They hence need to deal with the processing of information only. In contrast, consumers of articles which contain certain chemicals even carry the burden of accessing information about the dangerousness of the substances in question.

13.3.4 A Brief Summary

Secondary internal market regulation has implemented and perpetuated the concept laid down in the ECJ's decision in "Cassis de Dijon" according to which information-related regulation should be given preference over content-related regulation if the former has to be considered sufficient in the light of the protective purpose of the regulation. Assessing this point, one has to accept a trade-off between higher financial risks on the part of consumers and investors caused by increasing information problems and positive welfare effects through an enlarged market. Thus, the internal market legislator has adopted the concept of a "well-informed, observant and circumspect" consumer. However, the implementation of such a concept does not mean that an individual market player has to bear entirely the burden of information processing. Rather, internal market law considers individual cognitive limits and seeks to counter the risks of information deficits through various regulative mechanisms, though as far as possible without restricting the widened choice of products generated by the internal market in the first place.

While it remains in general the freedom of the individual market players to decide which transaction may correspond to their preferences, we may also find rules such as the required warnings against smoking tobacco that cannot anymore be understood as aiming merely at enabling consumers to reach an informed transaction decision, but that follow an explicit political agenda and seek to steer transaction decisions in this direction, though technically without restricting free product choice. However, such instances where the consumer is conceptualized as a person who is not able to act according to their own best interest remains exceptional, and hence, it would be misleading to postulate a "behavioural turn" in internal market policy. Yet it is important to recognize that every regulatory choice on which information has to be provided on the market and in which form it has to be provided involves an element of paternalism as it influences the informational basis that may establish the grounds for the decision-making process of market players. Thus, any rule that is meant only to facilitate perceiving and processing information contains a "behavioural facet", if only implicitly or as a matter of fact rather than intention, and weak in its nature.

13.4 Normative Requirements with Respect to the Individual Cognitive and Behaviour Concept to Adopt for Internal Market Regulation

In this section we will discuss how the normative concept of a market player as an addressee of internal market regulation is shaped by requirements of EU primary law. The fundamental freedoms as the paramount legal instruments to implement the internal market (Article 26(2) TFEU) establish a normative basis in this regard. Consequently, the idea of an internal market player as a "well-informed,

observant and circumspect", i.e. roughly speaking as a "smart and decent fellow" who shares essential features with the concept of a *homo economicus* serves as a basic model. Yet this line of reasoning may not explain the protective impetus and the "behavioural facet" we also may observe with regard to the normative idea of the internal market player as it becomes apparent considering internal-market legislation and the adjudication of the ECJ. We will argue that the rationale behind this normative dimension may be attributed to an increasing consideration of individual, non-market related rights enshrined particularly in the fundamental rights as part of EU primary law.

13.4.1 On the Normative Basis of a Regulatory Image of the Internal Market Player as a "Smart and Decent Fellow"

The concept of the internal market as embodied in the Treaties first and foremost aims at enhancing the social welfare of participating countries based on classical free trade theory. As obstacles to cross-border trade are removed, the choice of potential counter-parties will be expanded and the number of transactions will rise. This will entail a more efficient allocation of factors of production (capital and labour) and ensure that products may circulate freely to where they are remunerated best. This virtuous circle relies on "private initiative in free markets",[88] and assumes that any additional cross-border transaction shall enhance the utility of participating parties. It thereby presupposes that individual market players are capable of perceiving and processing transaction relevant information, and of making on such solid informational bases rational transaction decisions that actually meet their preferences.

Thus, the role that has been assigned to the market players by the internal market rationale does indeed conceive the individual actor as "well-informed, observant and circumspect" as it has been stated by the ECJ. The accentuated role that has been attributed to the individual market player through the normative programme outlined in the internal market provisions of the Treaties is further reflected in the Court's jurisprudence whereby these provisions "confer upon them rights which become part of their legal heritage".[89] Certainly, the outlined concept of internal market players does not exclude regulatory activities that may be characterized as market rational, i.e. for example rules that seek to ensure a sufficient informational basis for a transaction decision. The assigned role only presupposes that the individual may be empowered with the help of such assisting rules to reach transaction decisions that meet their preferences and enhance their individual utility.

[88] Grundmann, p. 510.

[89] ECJ, 5 February 1963, Case 26/92, *van Gend en Loos v Nederlandse Administratie der Belastingen*, [1963] ECR 1, 12.

Such a concept on the one hand grants market players the freedom to make autonomous decisions, but on the other hand also demands such autonomous decision-making and in this regard even expects a learning process from them.[90] This assumes that market participants who suffer material disadvantages as they neglect available information or who regret certain transactions because they had not carefully evaluated enough their preferences at the outset, shall benefit from such an experience and shall in future act more responsibly and clever on the market. The idea of such successful learning processes forms a classical justification of preference autonomy and personal responsibility as normative principles.[91] Consequently, fundamental freedoms such as the essential market integrative tools have been interpreted as instruments that extend party autonomy across borders.[92] Hence, the internal market concept as enshrined in the Treaties is basically hostile towards paternalistic content-oriented, market-rectifying[93] regulatory activities that seek to actively steer transaction decisions in a certain direction. It conflicts with an image of internal market players as individuals whose transaction decisions should be actively controlled by regulation as they suffer from cognitive deficits and from the effects of bounded rationality and therefore are considered incapable of responsible market activities in accordance with their own interest.

13.4.2 Normative Requirements to Consider Individual Weaknesses, Cognitive Deficits, and Effects of Bounded Rationality

The concept of the internal market player as a "smart and decent fellow" as sketched above rests only on one – though the most essential – dimension of the normative framework of internal market regulation. Yet it neglects that EU primary law does not only attribute an economic function and market-related rights to the individuals that are subject to regulatory acts of the Union. Rather these individuals are woven into a more complex normative network of rights and duties particularly as they have had fundamental rights and the status of European citizens conferred upon them. We will argue that it is the fundamental-rights dimension that accounts for the fact that internal market regulation is at least partly characterized by a consideration of individual weaknesses, cognitive deficits, and exceptionally even shows an openly paternalistic facet as illustrated by the regulation on the labelling of tobacco products. This raises the question whether the normative framework even

[90] Franck, *Absatzrecht*, p. 330.

[91] See Eidenmüller, pp. 329–333.

[92] See Müller-Graff, pp. 133–150.

[93] This terminology is borrowed from Wilhelmsson, *Contract Law*, p. 126 ("Therefore it is easy to see that the concept pair content-neutrality/content-orientation is quite closely related to another concept pair [...] the concepts are market-rational and market-rectifying regulation").

demands a more pronounced "behavioural turn" whereby regulatory activity has to focus even more on the effects of bounded rationality, seeking to cure "behavioural deficits", and steering the behaviour of market players in their own best interest.

Bounded Rationality, Efficiency Gains and Internal Market Regulation

Effects of bounded rationality reveal that under certain circumstances individuals systematically act against their own interests, i.e. they do not maximize their own utility. Therefore, regulation with the potential to counter such effects may both prevent individuals from acting irrationally against their own best interest and enhance social welfare.

A regulator that bans a certain product such as, for example, chewing tobacco, might achieve an immediate effect as individuals will consume less of the potentially health-damaging product and will, therefore, cause less harm to themselves, which will in turn reduce costs to the health system and save on human capital. Moreover, a regulator could hope to change preferences which might even reduce the need for regulation in the long run. A product that is generally less consumed might be less desired (but sometimes perhaps even more). It is conceivable that a certain (mandatory) level of consumer protection "could instill in European consumers a new preference for extended rights [. . .] that might positively affect the well-being of those consumers in the long run, even if most of them did not have the preference in the beginning and were not willing to pay the price for the rights and protections afforded by the legal rules".[94]

But perhaps a high level of consumer protection may in the long term have the unwelcome effect that individuals are less able to take responsibility for their own matters and thus become even more dependent on protective regulation.[95]

However that may be, it is essential to stress that potentially welfare-enhancing effects as sketched above *taken in isolation* do not justify internal market regulation. The Treaties do not provide the internal market legislature with a carte blanche to introduce (supposedly) welfare-enhancing market regulation. It is the underlying rationale of any internal market law to enhance (allocative) efficiency *through market integration*. Efficiency gains through driving back the (supposedly) welfare damaging consumption of certain products by means of bans, warnings etc., or welfare gains through shaping consumers' preferences according to their (supposedly) own best long-term preferences do not as such constitute a factor which could establish a competence for internal market regulation.[96]

[94] Gómez, p. 199.

[95] See *infra* Sect. 13.5.

[96] Franck, 'Wert ökonomischer Argumente', para. 27.

On the Impact of Fundamental Rights on the Regulatory Concept of Internal Market Players

The market-player concept of internal market regulation largely relies on the market integrating function as it is embodied in the fundamental freedoms. It is indeed convincing to take their rationale as a starting point to evaluate the market-player concept.

However, during the last few years the ECJ has attributed a significant role to fundamental rights also in the context of the application of fundamental freedoms. As the Court highlighted in "Carpenter", fundamental rights safeguard activities and interests such as the respect for family life that in fact have to be considered "conditions" under which fundamental freedoms may be exercised.[97] Hence, as "Carpenter" illustrates, the exercise of fundamental freedoms should be considered as being embedded in a normative framework set up by fundamental rights.

Further implications of these findings were illustrated by the ECJ's judgments in "Schmidberger", and subsequently confirmed *inter alia* in "Viking" and "Laval" where the Court held that fundamental rights may justify a restriction of fundamental freedoms.[98] Accordingly, if measures that implement the integration of the internal market restrict fundamental rights, the weight of the restriction of these fundamental rights has to be balanced against the weight of the general interest in a functioning internal market and the individual rights conferred by fundamental freedoms as recognized in "van Gend en Loos".[99] Viewed from the perspective of the internal market legislature, fundamental rights turn into duties to protect the individuals as they are affected by activities in exercise of fundamental freedoms, and which require the European legislature to strike a balance when acting as a regulator. This development reflects previous suggestions to attribute a horizontal effect to fundamental rights under EU law.[100]

Hence, individual weaknesses, cognitive constraints and the effects of bounded rationality must not be ignored *per se* in the context of internal market regulation, but instead need to be taken into account according to the requirements set by fundamental rights, and have to be balanced against the rights resulting from fundamental freedoms. It is this aspect that explains why internal market regulation does not follow the illustrated stylized information paradigm, but also aims at

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[97] ECJ, 11 July 2002, Case 60/00, *Mary Carpenter v Secretary of State for the Home Department*, [2002] ECR I-6279, para. 39.

[98] ECJ, 12 June 2003, Case C-112/00, *Eugen Schmidberger, Internationale Transporte und Planzüge v Republik Österreich*, [2003] ECR I-5659, para. 74; ECJ, 11 December 2007, Case C-438/05, *International Transport Workers' Federation and Finnish Seamen's Union v Viking Line ABP and OÜ Viking Line Eesti*, [2007] ECR I-10779, para. 45; ECJ, 18 December 2007, Case C-341/05, *Laval un Partneri Ltd v Svenska Byggnadsarbetareförbundet and Others*, [2007] ECR I-11767, para. 93.

[99] ECJ, 12 June 2003, Case C-112/00, Eugen Schmidberger, *Internationale Transporte und Planzüge v Republik Österreich*, [2003] ECR I-5659, para. 81.

[100] Weiler, p. 332.

protecting particularly vulnerable market players, seeks to facilitate information processing, and partly even seeks to steer the process of decision-making in a certain direction. And as the European institutions are obliged to protect the mental and physical integrity of persons,[101] it is consistent that the ECJ, while it has adopted the concept of a "well-informed, observant and circumspect" consumer in its adjudication regarding deceptive marketing practices, does apply a more protective standard when a marketing activity entails the risk that a misapprehension on the part of an addressee poses not just financial but health risks to that individual.[102] This is essentially why Union consumer law has always followed a double-headed approach, aiming primarily at the establishment of an internal market but at the same time striving for protective goals.[103]

This raises the question as to normative guidelines set out by EU law on how the balancing between the fundamental freedoms' impetus to grant greater freedom for economic activities and the protective goal pursued through fundamental rights should be accomplished. In "Schmidberger" the ECJ granted the lawmaker a "wide margin of discretion" in this regard.[104] Thus, it seems reasonable to suppose that the legislature also enjoys a margin of discretion when it has to decide to what extent it relies on the normative concept of the internal market player as a "smart and decent fellow" with regard to regulatory measures that secure the exercising of fundamental freedoms and the functioning of the internal market, and to what extent such regulatory activities have to be guided by a protective impetus required by fundamental rights.

However, in other cases the ECJ stipulated more specific instructions as to this regulatory balancing task. In "Affish" the Court stated that whenever a contested decision is intended to guarantee the protection of public health "it must take precedence over economic considerations".[105] Such a finding is supported by Article 168(1) TFEU, whereby a "high level of human health protection shall be ensured in the definition and implementation of all Union policies and activities", and by Article 114(3) TFEU, according to which the Commission has to take a high level of health into account when proposing measures under Article 114(1) TFEU. While the wording of the provisions in question suggests a distinction between public and individual health issues, this seems to be – at least in our context – of no significance. As the protection of individual health and the protection of public

[101] See Article 3(1) EU Charter of Fundamental Rights.

[102] See *supra* at note 48.

[103] Wilhelmsson, 'Confident Consumer', p. 319.

[104] ECJ, 12 June 2003, Case C-112/00, *Eugen Schmidberger, Internationale Transporte und Planzüge v Republik Österreich*, [2003] ECR I-5659, para. 82.

[105] ECJ, 17 July 1997, Case C-183/95, *Affish BV v Rijksdienst voor de Keuring van Vee an Vlees*, [1997] ECR I-4362, para 43; approved in ECJ, 19 April 2012, Case C-221/10 P, *Artegodan GmbH v European Commission*, [2012] ECR I-0000 (nyr), para 99.

health are partly associated with different competence regimes,[106] both may be conceptually distinguished. However, the ECJ has implicitly assumed that policy choices for public health protection are intertwined with human health protection and may therefore be referred to interchangeably.[107] The Treaty also reflects this view as "human health" in Article 168(1) TFEU is stipulated as part of Title XIV "public health".

Neither Article 168(1) TFEU nor Article 114(3) TFEU provide for a competence norm, hence no duty can be imposed on the EU institutions to implement pro-health regulation. One may nonetheless deduce the following aspect from the rationale of "Affish" reading it together with Article 168(1) TFEU and Article 114(3) TFEU: When EU institutions conduct a balancing test and thereby consider concerns of public health in an internal market context, this aspect shall prevail over a concept that is solely based on an impetus to expand the freedom for economic activities in the interest of internal market integration. Thus, under such circumstances the normative image of an internal market player as a "smart and decent fellow" has to be modified accordingly, i.e. individual weaknesses, cognitive defects etc. that give reason to fear that market activities might entail risks of health damage must not be ignored based on a internal market rationale or an information paradigm in a pure form.

The Implementation of Citizenship Rights and its Impact on the Concept of an Internal Market Player

In 1992 the Member States introduced provisions on a "Citizenship of the Union" through the Maastricht Treaty. These provisions confer upon any person holding the nationality of a Member State *inter alia* the individual right to move and reside freely within the Union's territory,[108] and the political right to take part in elections to the European Parliament and to municipal elections in their Member State of residence.[109] Beyond those rights which are expressly mentioned in the citizenship provisions[110] the concept of an EU citizenship has to be understood as a label for the bundle of rights that are conferred upon the nationals of EU Member States in the Treaties.[111] As such the concept signals that EU law conceives individuals not

[106] When common safety concerns are at stake, public health is according to Article 4(2)(k) TFEU part of the EU's shared competence regime, while human health is according to Article 6(a) TFEU only within the EU's competence to carry out actions to support, coordinate or supplement the actions of the Member States.

[107] ECJ, 5 October 2000, C-376/98 *Federal Republic of Germany v European Parliament and Council of the European Union* (Tobacco I), [2000] ECR I-8419, para. 88.

[108] See Article 20(2)(a) and Article 21 TFEU.

[109] See Article 20(2)(b) and Article 22 TFEU.

[110] Article 20(2) TFEU and Articles 21 to 24 TFEU.

[111] Article 20(2) 1st sentence TFEU.

only instrumentally, i.e. restricted to their "function" as producers or consumers of goods and services or as providers of capital or even as a mere factor of production ("labour"). Rather, the aggrandisement of the diverse individual rights through their bundling under the status of an EU citizenship recognizes individual human beings beyond their role as economic actors also as participants in the political sphere and as individuals with social needs.

While acknowledging this rationale of the implementation of the status of a "Citizenship of the Union", it still remains unclear to what extend EU citizenship as a legal concept does effectively grant broader rights to individuals beyond those which are expressly mentioned in Articles 20 to 24 TFEU or which are already embodied in the primary or secondary law of the Union.[112] The ECJ has referred to Union citizenship in cases where it sought to substantiate an application of the principle of non-discrimination on grounds of nationality (Article 18 TFEU) to grant persons a right of access to social benefits without referring to their role as economic actors, e.g. in the cases of students[113] or job-seekers.[114]

However, while the concept of an EU citizenship points to the fact that EU law not only recognizes the individual isolated in its economic function, it is hard to see how EU citizenship – at least as it stands now in its character as a legal concept – could raise conflicts with a certain construction of internal market regulation or in particular of the fundamental freedoms beyond those conflicts that are already provoked by the application of fundamental rights (that are, certainly, also bundled under the "label" EU citizenship). Though the rationale of EU citizenship may almost certainly be associated with a normative assignment to ensure that "the economic law provisions are interpreted with due respect for the dignity of the persons",[115] the mechanism at work resembles the impact of fundamental rights we have seen in "Carpenter", but it misses the conflicting dimension we have seen with regard to fundamental rights e.g. in "Schmidberger", "Viking" or "Laval". As illustrated by these cases, the recognition of fundamental rights may provoke direct conflicts with the impetus of internal market law to expand economic freedom for market actors across borders, and which therefore entails the need for a balancing of opposing rights and interests. In contrast, social or political rights that are established through the principle of non-discrimination construed and strengthened in the light of EU citizenship seem to add a different but not conflicting dimension to a pure economic and market-oriented perspective.

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[112] See Dennis-Jonathan Mann and Kai Purnhagen, 'The Nature of Union Citizenship between Autonomy and Dependency on (Member) State Citizenship – A Comparative Analysis of the Rottmann Ruling, or: How to Avoid a European Dred Scott Decision?'.

[113] See ECJ, 20 September 2001, Case C-184/99, *Rudy Grzelczyk v Centre public d'aide sociale d'Ottignies-Louvain-la-Neuve*, [2001] ECR I-6193, paras. 29–37.

[114] ECJ, 23 March 2004, Case C-138/02, *Brian Francis Collins v Secretary of State for Work and Pensions*, [2004] ECR I-2703, paras. 61–63.

[115] Cf. Weatherill, *EU Law*, p. 463.

Thus, "Citizenship of the Union" as a legal status represents an allocation of not only economic but also of political and social rights to Member States' citizens and thereby illustrates that EU law conceives persons not only restricted to their economic "function". However, the concept of the EU citizen must still be seen through the rationale of EU law. The social and political facet of the concept of EU citizenship therefore does not resemble a new, transformed or other form of nation-state citizens, but rather "corresponds to the set of rights granted to individuals as participants and beneficiaries of economic integration".[116] In this sense, it implements additional but not conflicting normative aspects of internal market integration since these additional requirements stem from the benefits of economic integration achieved *inter alia* by economic regulation. Hence, economic integration and the regulation aiming at this end form the basis of EU citizenship rather than the other way round.[117] Therefore, with regard to our topic we may conclude that from EU citizenship in its legal effect beyond the relevance of the bundled rights and duties, one may not deduce normative guidance on the shape of economic regulation, particularly as to the question to what extent EU law demands or allows for a normative concept based on a consciously exaggerated assumption of the individual's capability to perceive and process information and of rational decision-making, or rather to what extent it requires the consideration of individual weaknesses, cognitive restraints, or the effects of bounded rationality.

Article 114 TFEU as the Pivotal Competence Norm for Internal Market Regulation

The European Union has only the powers the Member States specifically conferred on it in the Treaties (Article 5(2) TEU). Thus, the Union has no general power of market regulation. As it is laid down in Article 114(1) TFEU by reference to Article 26 TFEU, and as it has been emphasized by the Court, the European legislature must ensure that any regulatory measure enacted on the basis of Article 114 TFEU as the pivotal competence norm for internal market legislation "must genuinely have as its object the improvement of the conditions for the establishment and functioning of the internal market".[118]

Beyond that, Article 114(1) TFEU does not contain any substantive guideline on the harmonizing measures for which it provides the legal basis. However, Article 114(1) TFEU must not be read in isolation, but in connection with certain qualifications. According to Article 114(3) TFEU the European Commission when it envisages a proposal on a harmonization of national regulation based on Article

[116] Maduro, p. 340.

[117] See from the perspective of consumer policy Davis, p. 249.

[118] ECJ, 5 October 2000, Case C-376/98, *Federal Republic of Germany v European Parliament and Council of the European Union*, [2000] ECR I-8419, para. 84.

114(1) TFEU relating to health, safety, environmental protection, and consumer protection has to take "as a base a high level of protection". In addition, the European Parliament and the Council shall also "seek to achieve these objectives".

While it has been remarked that this wording does not compel the EU institutions to enact measures in accordance with a high level of protection,[119] Article 114(3) TFEU certainly does not only contain a general appeal for political consideration of those protective goals. Rather it has to be understood as a binding normative guideline that at least prevents the EU legislature from ignoring the mentioned non-economic objectives or from harmonizing protective standards at the lowest conceivable level. In this respect, Article 114(3) TFEU reflects normative requirements that are laid down elsewhere in EU primary law, for instance in horizontal clauses such as Article 11 TFEU concerning environmental protection and Article 12 TFEU concerning consumer protection. Thus, Article 114(3) TFEU takes away from the European legislature the option to generally neglect any individual weaknesses, cognitive constraints etc. of market players, such as, for example, by adopting a stylist information paradigm as indicated above that imposes the burden of perceiving and processing information and reaching a rational transaction decision completely upon each individual market player.

This raises the question if contrariwise Article 114(3) TFEU forces the internal market legislature to fully take into account individual defects and weaknesses that are revealed by behavioural sciences ("taking account in particular of any new development based on scientific facts") and excludes the option of adopting a normative concept of internal market players that at least to some extent neglects those insights. Does Article 114(3) TFEU in fact require a "behavioural turn" in internal market regulation, understood as a significant expansion of regulatory interventions based on an impetus to influence market players' conduct in a paternalistic way?

We may answer this in the negative as such an understanding and implementation of Article 114 TFEU would in fact result in the harmonizing of regulation at the highest conceivable level of protection. Such an approach would – to take up again the argument of Advocate General *Capotorti* in "Cassis de Dijon"[120] – ultimately amount to a prescription of uniform products. However, if internal market regulation were to put an end to the diversity of products available on the internal market, it would in fact eliminate an essential purpose of its concept, namely to open markets to enrich all internal market players with a greater variety of products, thereby better serving the diverse interests of market players. Article 114 TFEU neither legitimizes, nor does it demand regulatory measures with such counterproductive effects on internal market integration as it is the internal market rationale that forms the basis for any regulatory measure in the first place.[121]

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[119] Ehlermann, p. 388; Craig and de Búrca, p. 618.

[120] See *supra* note 41.

[121] Cf. ECJ, 13 May 1997, Case C-233/94, *Federal Republic of Germany v European Parliament and Council of the European Union*, [1997] ECR I-2405, para. 48: "Admittedly, there must

Hence, what Article 114 TFEU calls for is a balancing between a promotion of the functioning of the internal market as the prior ambition of any regulatory measure adopted on that basis, and a protection of those interests mentioned in Article 114(3) TFEU. Taking a look at the concept of man in economic regulation, in particular the requirement to consider concerns of health, (product) safety, and consumer protection may be of relevance. However, the internal market legislature enjoys a wide margin of discretion in performing this balancing assignment.[122] In search of normative guidance for an exercise of this discretionary power one may refer in particular to the provisions on fundamental rights. Therefore, regulatory measures concerning the protection of the physical integrity of market players ("health", [product] "safety") should tend to be characterized by a relatively higher protective standard than measures that are only related to the pure financial interests of market players.

To sum up briefly, Article 114 TFEU neither allows internal market regulation to completely neglect individual weaknesses, cognitive restraints etc. and to impose, for example, the informational burden completely upon each individual market player, nor does it require a "behavioural turn" from the EU legislature, i.e. a focus on regulatory measures that aim at countering effects of bounded rationality etc. Rather, Article 114 TFEU demands from the legislature that it balances the objective interest in establishing a functional internal market that entails a tendency towards a lower degree of regulatory intervention with the protective purposes laid down in Article 114(3) TFEU. The EU institutions thereby enjoy a wide margin of discretion.

13.5 Regulatory Consideration of Concerns of Behavioural Sciences: Some Sceptical Remarks

EU law provides for a normative basis that legitimizes or to some extent even demands that the legislature considers in issuing economic regulation also the individual weaknesses, cognitive limits and biases of market actors as well as the potential effects of bounded rationality. Yet we have also seen that the decision for such regulatory intervention and the way it is implemented remain largely at the discretion of the legislature.

Any kind of regulatory intervention faces a number of obstacles along its way to successful implementation,[123] and regulatory ambitions in response to individual cognitive and behavioural deficits constitute no exception in this regard. It is in the nature of regulation that it requires the lawmaker to find a standardized protective

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be a high level of consumer protection [...]; however, no provision of the Treaty obliges the Community legislature to adopt the highest level of protection which can be found in a particular Member State."

[122] Ehlermann, p. 389.

[123] See for some accounts *inter alia* Hood, Rothstein and Baldwin, pp. 26 et seqq.

level that applies for all addressees,[124] in the case of internal market regulation across Europe. But risk perception is different among people and cultures, and it may change without there being observable patterns.[125] A centralized rule-making in Brussels that produces harmonized economic regulation may in particular not account for heterogeneous preferences that are influenced by quite strong divergent cultural and social backgrounds throughout the Union. Persuasion, acceptance, and ultimately the effects of such regulatory measures will accordingly vary to a high degree, and therefore such regulation bears significant risks of being ineffective and inefficient or even of producing counter-productive results and undesired side-effects.

A negative long-term effect that has particularly been associated with a "behavioural universe" is that market actors "don't learn much" where regulation does not expect learning processes from individuals in their role as market participants but seeks to steer their behaviour in the "right" direction from the outset.[126] Thus, regulation with a "behavioural impetus" risks decreasing the capacity of self-control, phasing out the possibility to let market players become confident market actors who learn from their positive and negative experiences.[127] Market players whose conduct have constantly been influenced by regulation that aims at counteracting cognitive biases and effects of bounded rationality, will ultimately become more and more dependent on regulation as they may no longer be able to take responsibility for matters regarding their own welfare. There seems to be a risk that regulation which attempts behaviour modification might result in a regulatory spiral, confirming its own legitimacy, and even creating a need for constantly stronger regulatory interventions.

Potential impediments to an effective implementation of a regulatory concept that seeks to counter cognitive biases and the effects of bounded rationality, as well as likely counter-productive effects and negative side-effects have to be taken into account by European institutions when they define the protective standard of a harmonizing measure, and when they balance individual rights to free trade and the objective interest in a functioning internal market on the one hand with the objective to prohibit a race to the bottom in pursuing certain protective purposes on the other. A call for regulatory intervention must not become a sort of knee-jerk reaction to results of behavioural sciences. Regulators are encouraged not to take these findings as a welcome excuse to expand their field of activities, as a justification to optimize rules that are supposed to counter market failures or to implement market-rectifying intervention. Rather they should consider conceiving those insights as a cause for lowering regulatory ambitions to a realistic level.[128]

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[124] See Sunstein, *Free Markets*, pp. 130 et seqq.

[125] Bottalico, pp. 427 et seqq.

[126] Burgess, p. 12.

[127] Bovens, p. 211.

[128] Franck, 'Wert ökonomischer Argumente', para. 47.

13.6 Conclusion

1. The economic rationale behind the legal concept of an internal market rests upon classical free trade theory as it aims at an enhancement of allocative efficiency through removing barriers of cross-border trade. Yet functioning markets also require positive economic regulation, for example regulation that counters the risks of adverse selection due to systematic information deficits. The ECJ's decision in "Cassis de Dijon" reflects a potential trade-off between the liberalizing impetus of internal market regulation and the protective objectives pursued by economic regulation, be it of domestic or EU law origin: the stricter the level of the latter, the more the diversity of products available in the internal market as well as the flexibility of production factors will be reduced.
2. Therefore, the fundamental freedoms subject the implementation of positive protective goals through economic regulation to a proportionality test on the basis of which the Court developed *inter alia* the normative concept of an internal market consumer as "reasonably well-informed and reasonably observant and circumspect". This concept implied that for reasons of internal market benefits, market players have (at least to some extent) to bear the burden of perceiving and processing information that is transaction relevant as well as disadvantages should they be ill-equipped to cope with this assignment. The internal market legislator echoed this concept of internal market actors as it explicitly referred to it in secondary legislation but also as it implemented a preference for giving market actors free access to information over content-related regulation.
3. EU institutions have never adopted a normative market player concept solely guided by the liberalizing rationale of internal market law. In particular, the Court stated exceptions in circumstances where misconceptions on the part of consumers posed health risks, and various examples illustrate how the EU legislator assists market players in perceiving and processing information and even seeks to steer their decision-making process in a certain direction. In this respect, a clear-cut distinction is not possible as there is nothing like a purely informational but content-neutral rule since every regulatory choice as to which information has to be provided on the market and in which form involves an element of paternalism as it influences the informational basis that may establish the ground for the decision-making process of market players. Thus, any rule that is meant to facilitate perceiving and processing information contains a "behavioural facet", if only implicitly or as a matter of fact, and weak in its nature. In contrast, only exceptionally internal market regulation reveals paternalism in a strong form, i.e. instances where the internal market legislator conceived the individual addressees of its economic regulation as inapt to a market conduct that served their own best interest due to cognitive biases or effects of bounded rationality. Thus, looking at positive internal market law no "behavioural turn" may be diagnosed.
4. Internal market regulation and the normative market player concept embodied therein are the result of a balancing assignment attributed to the internal market

legislator by EU primary law. It is essentially fundamental rights that may oblige regulators to take into account individual weaknesses, cognitive limits and biases as well as the effects of bounded rationality as revealed by insights of behavioural sciences. Therefore, the internal market legislator must not take an optimization of allocative efficiency according to the free trade rationale enshrined particularly in the fundamental freedoms as its sole guidance for economic regulation. Yet normative requirements as they follow from the fundamental rights and as they are also reflected in Article 114(3) TFEU neither demand nor legitimize a "behavioural turn", i.e. a change in the policy of internal market regulation according to which an impetus to actively steer market players' conduct in their own best interest should become an essential ambition. Such a paternalistic shift in regulatory policy would conflict with the internal market rationale that only grants the regulatory competence to EU institutions in the first place, which, however, enjoy a wide margin of discretion in this regard.

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Chapter 14
Economic Principles in Antitrust Law in the Aftermath of the More Economic Approach

General Aspects, Current Issues and Recent Developments

Claudia Seitz

Abstract More than a decade after progressive discussions of economic tendencies in traditional antitrust law[1] and an increasing importance of economics in antitrust assessments in Europe,[2] the relationship between economics and law in the assessment of antitrust cases has still not yet adequately been solved. Although a "more economic approach" has been discussed widely by economists and lawyers over the past years in the EU,[3] in the EU member states[4] as well as in Switzerland,[5] there are still some important issues which are not yet solved.[6]

The key questions are, whether a form-based legal approach should be followed, whether an effects-based economic approach is better suited to cover antitrust cases, or whether an approach that combines both approaches is possible, at least in some cases.

[1]In this essay the term "antitrust law" of the US legal system is used. This term is employed synonymously for the term "competition law" which is used as the common term under EU law.

[2]See for example as one of the starting points of this economic approach the European Commission's White Paper on Modernisation of the Rules Implementing Articles 85 and 86 of the EC Treaty ('White Paper'), OJ C 132, 12 July 1999, pp.1 et seqq.

[3]Ewald, pp. 15 et seqq.; Hildebrand, *Role of Economic Analysis*, pp. 105 et seq.

[4]For Germany see for example Böge, pp. 726 et seq.; Epple, pp. 220 et seqq.

[5]For Switzerland see for example Künzler, pp. 5 et seqq.; Zäch and Künzler, pp. 269 et seqq.

[6]For a general overview see Dreher and Adam, 'More Economic Approach', pp. 259 et seqq.; Hildebrand, 'more economic approach', pp. 513 et seq.

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14.1 Introduction

The relationship between law and economics is widely discussed – not only in economic and legal academic circles, but also in practice. Although questions regarding the interaction between these two disciplines in antitrust law are not new, the impacts of the "more economic approach" discussion are – even after several years of debates and research – still not yet clear.

The reason for this may be seen in the fact that restraints of competition are a common subject in both law and economics.[7] This means that both disciplines deal with the same subject. On the other side, however, both have their own objective, procedural methods and approach.[8]

Several key elements of antitrust law – e.g. the definition of "competition" as such, the definition of the "relevant market", the question of "market power" – are not legal but economic terms, although they play a central role in the legal framework of antitrust law provisions and in the assessment of antitrust cases. The theory of competition deals with the nature, the conditions and the functions of market economy and competition. This leads to the question of the relationship between both disciplines and is also a question of which theory the competition policy should follow.

Given the limited scope of this paper, it is neither the aim to find the final answer to all questions currently discussed in this area, nor to find a clear and final solution regarding the relationship between law and economics in the area of antitrust law. Thus, this paper will focus on the antagonism between the traditional form-based approach on the one side and the new effects-based approach under the "more economic approach". Based on thoughts taken from the US antitrust law, the economic influence and legal application in antitrust law will be analysed. The focus is not on achieving final solutions, but rather to discuss general principles, current issues and recent developments in the aftermath of the introduction of the "more economic approach" to antitrust law.

The main conclusion of this paper is the need for a compromise between the form- and the effects-based approach. In the end and at least under the current legal system in the EU and in most of the EU member states as well as in Switzerland, lawyers have to interpret, apply and adjust the interpretation of the changing economic theories and models. However, these decisions are only as good and valuable to competition as they also take into consideration economic thinking.

In order to explain the importance of economic principles in modern antitrust law – as the theoretical background the "more economic approach" – the tension between an effects-based approach and a form-based approach in antitrust law will be assessed and critically appraised in the following section.

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[7] Regarding the purpose of legal rules and the product of competition Mestmäcker, pp. 26 et seq.; Basedow, p. 712; Böge, p. 726; Budzinski, p. 119; Carlton, p. 155; Ehlermann, p. 537; Röller, p. 37.

[8] Antitrust cases by antitrust authorities in the EU and in Switzerland as well as by the EU Commission are assessed by a team of lawyers and economists.

14.1.1 Traditional Importance of Economic Principles in Modern Antitrust Law

From an economic perspective, competition can be assessed based on economic models. Economic interaction is considered by empirical evidence, which is required by these economic models in order to analyse and predict certain effects of market behaviour. Antitrust law, however, tries to cover this economic interaction in legal provisions.

Competition, for example, is a process that forces firms to be responsive to the needs of consumers, e.g. regarding price, quality and variety. Furthermore, it is also a selection mechanism, in which undertakings that are more efficient replace the less efficient undertakings. The application of antitrust law refers to economic situations.

The assessment of economic situations often requires an economic analysis. It is essential that legal rules do not endanger a competitive market or have detrimental effects. Many of the key concepts of antitrust law – for example, the concepts of competition, monopoly, oligopoly and barriers to entry – are concepts derived not from a law perspective but from economics.[9]

14.2 More Economic Approach: Effects-Based Approach Instead of Form-Based Approach

Economic concepts play an important role in almost all parts of antitrust law. There is, for example, an increasing importance of the "more economic approach" in all parts of antitrust law, especially Article 101 and 102 of the Treaty of the Functioning of the European Union ("TFEU"),[10] the European Merger Control Regulation ("ECMR")[11] and in the concept of state aids under Article 107 TFEU.[12] Significant impacts of economic concepts are visible especially in the context of the abuse of market dominance under Article 102 TFEU. An economic-based approach, however, requires careful examination of how competition works in each particular market in order to evaluate how specific company strategies affect consumer welfare.

Especially in the context of Articles 101 and 102 TFEU, the antagonism between a more form-based or a more fact-based approach leads to the question which objective is of higher value and therefore preferential. A case-by-case economic

[9] Bishop and Walker, pp. 2 et seqq.

[10] All references to Article 101 and 102 are made to Article 101 and 102 of the Consolidated Version of the Treaty on the Functioning of the European Union ("TFEU"), OJ 2012 C 326, 26 October 2012, pp. 49 et seqq.

[11] Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings ("European Merger Control Regulation", "EMCR"), OJ 2004 L 24, 29 January 2004, pp. 1 et seqq.; See also Seitz, 'Ökonomische Analyse und Risikoverteilung', pp. 719 et seq.

[12] Seitz and Breitenmoser, pp. 445 et seqq.

analysis of an effects-based approach takes into consideration empirical evidence on the basis of economic models. This may lead to a more appropriate assessment of each single case and allows or disallows economic behaviour. The outcome of this assessment may be different under an effects-based approach.

On the other side, the application of a form-based approach leads to a system that is easy to handle by lawyers. It is cost- and time-efficient, because no detailed economic analysis is needed. Aside from this, the application of a form-based approach leads to foreseeable results and thus guarantees legal certainty for the companies involved.

This leads to the question which approach should be followed when dealing with antitrust law matters: if the focus is on law, this leads to a more form-based approach; whereas the focus on economics induces a more effects-based approach.

This antagonism is currently apparent in all areas of antitrust law in important western jurisdictions. It is, for example, the subject of discussion within the field of vertical restraints under the European antitrust law[13] as well as under the US antitrust law,[14] where the US Supreme Court's *Leegin*[15] decision is a recent example.

In its *Leegin* decision the US Supreme Court reversed its almost 100 year old doctrine of the Dr. Miles decision[16] regarding a per se prohibition of vertical price restraints. In detail the US Supreme Court reversed the doctrine that minimum price targets were illegal per se under Section 1 Sherman Act and decided that even such cases need to be assessed by a rule of reason-approach, which means an assessment by their (economic) effects.

Although this antagonism is a general question, the present analysis focuses on the area of Article 102 TFEU as an example, where this interaction is eminently apparent.

14.3 The "More Economic Approach" in the Assessment of Abuses of Market Power as an Example

14.3.1 The "More Economic Approach" Assessment of Market Power and Abusive Behaviour by the EU Commission

In 2004, the EU Commission's DG Competition began a review of the policy applicable to Article 102 TFEU to determine whether this policy should be revised to better serve the core objective: protecting competition in the market as a means of enhancing consumer welfare and ensuring an efficient allocation of resources.[17]

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[13] Kasten, p. 994; Kneepkens, pp. 656 and 664; Schwaderer, pp. 653 et seq.

[14] Beard, Kaserman and Stern, pp. 75 et seq.

[15] US Supreme Court, Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

[16] US Supreme Court, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).

[17] Joelson, p. 369; Farrell and Katz, p. 3.

This review led to the EU Commission DG Competition's Discussion Paper of December 2005 on the application of Article 82 of the EC-Treaty[18] (now Article 102 TFEU) to exclusionary abuses ("Discussion Paper"), which focuses on exclusionary abuses only whereas exploitative abuses were not covered by this Paper.[19]

The objective behind the Discussion Paper was the introduction of a new approach in the application of the relevant provisions: the enforcement of Article 102 TFEU should be undertaken in a more transparent way considering the effects of market power as well as abusive behaviour. According to the EU Commission this should be done on the basis of economic analysis, which is necessary both as guidance to the private sector (who must comply with Article 102 TFEU) and to the competition authorities and courts of the EU Member States in order to facilitate a consistent approach in the application of Article 102 TFEU.[20]

The Discussion Paper was also designed to promote a debate on what policies the EU Commission should pursue in enforcing Article 102 TFEU in the future. Moreover, the Discussion Paper suggested a framework for the continued enforcement of Article 102 TFEU, building on the economic analysis carried out in recent cases of the EU Commission.

According to the Discussion Paper, exclusionary conduct may escape the prohibition of Article 102 TFEU if the dominant company can provide an objective justification for its behaviour or it can demonstrate that its conduct produces efficiencies that outweigh the negative effect on competition. In summary, the Discussion Paper suggested that exclusionary conduct that does not harm consumers is not an abuse. Therefore, a firm can escape an abuse finding by showing an objective justification *or* by efficiency defence. In the past, the application of Article 102 TFEU has been vigorously criticised for being formalistic and for lacking economic rationale.[21]

Besides the conduct, the Discussion Paper also examines the importance of market shares for the definition of dominance by explaining that a high market share does automatically not mean market dominance.[22] The ways to define market dominance under the new "more economic approach" of the EU Commission need to be analysed, as the assessment of dominance should not solely rely on market shares.[23] The key question in this context will be what kind of effect this market power will have on the market and this is an empirical question.[24]

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[18] Article 102 TFEU was referred to as Article 82 EC-Treaty at that time.

[19] European Commission, *Discussion Paper*, pp. 15 et seqq.

[20] Schmidt and Voigt, p. 1097.

[21] See for example Rousseva, p. 605; Kallaugher and Sher, pp. 263 et seqq.; Kamann and Bergmann, pp. 83 et seqq.; Sinclair, pp. 491 et seqq.; Ridyard, pp. 286 et seqq.

[22] This Discussion Paper focuses on exclusionary abuses only, exploitative abuses are not part.

[23] Kerse and Khan, p. 21; Werden, p. 53.

[24] Bishop and Walker, p. 186; Baker and Rubinfeld, p. 386.

14.3.2 Objective Justifications and Efficiencies

EU Antitrust Law

Objective justifications can be divided into "objective necessity defences" – where a dominant firm may show that the conduct concerned is objectively necessary – and "meeting competition defences" – where behaviour would otherwise constitute a pricing abuse.[25]

Regarding the efficiency defence, the Discussion Paper defines that a dominant firm must demonstrate that four conditions are fulfilled cumulative: (i) The efficiencies are a result of the conduct concerned; (ii) the conduct is indispensable to realise these efficiencies; (iii) the consumers benefit from these efficiencies and (iv) the competition is not fully eliminated.[26]

One very important question arises concerning the new model of efficiencies in the context of Article 102 TFEU: who shall bear the burden of proof? Generally, under EU antitrust law it is the company who is claiming that behaviour may be legal because of existing efficiencies. Although this problem may also arise with regards to objective justifications, it is much more difficult to prove that certain behaviour has certain efficiencies because of a lack of information and market data.

In general and according to the current practice of the EU Commission and the antitrust authorities of the EU Member States, antitrust authorities have to show the presence of significant anti-competitive harm, while the dominant firm should bear the burden of establishing credible efficiency arguments. Requiring consistent economic arguments grounded on established facts may lead to the assumption of constraining the antitrust authorities or the firms. A consistent treatment of the various forms of behaviour, however, enhances the predictability and the effectiveness of antitrust law enforcement.

The problem is that once certain behaviour falls under a category of abusive behaviour, there is a presumption of anticompetitive effects flowing from this behaviour. This leads to the question, whether is not the Commission who is obliged to prove that there is an anticompetitive effect, but the company who has the burden to prove that a given behaviour causes efficiencies under Article 102 TFEU.

In general, the Discussion Paper differs partly significantly from previous practice in its treatment of efficiencies especially since the "efficiency defence" has not been recognised as a justification by the EU Courts so far.[27]

[25] European Commission, *Discussion Paper*, p. 25. See also Loewenthal, pp. 456 and 464.

[26] European Commission, *Discussion Paper*, p. 26.

[27] Dreher and Adam, 'Abuse of Dominance', pp. 278 et seq.

US Antitrust Law

Per se *rule*s are a model developed under the US antitrust law system.[28] The per se standard assumes that certain types of business arrangements are inherently anticompetitive, rarely if ever justified by legitimate business concerns, and therefore per se unreasonable and illegal under Section 1 of the Sherman Act.[29] This shows that the per se rule is a model of Section 1 Sherman Act only and allows – similar to the system of Article 101 TFEU – exemptions under certain circumstances. Section 2 Sherman Act, however, is generally not covered by per se rules – which is also similar to Article 102 TFEU.

The benefits associated with the per se approach are business certainty, litigation efficiency, and deterrent effect.[30] These benefits provide real cost savings from the standpoint of litigation expense, the administration of justice, and judicial resources. Indirect cost savings are also achieved by allowing regulators and the judiciary to focus resources on cases that are not clearly anticompetitive and may present real pro-competitive efficiencies.[31]

The predictability and legal certainty of per se rules have been confirmed by the US Supreme Court in *Topco*, where the Supreme Court found that "without the per se rules, businessmen would be left with little to aid them in predicting in any particular case what courts will find to be legal and illegal under the Sherman Act".[32] Furthermore, the Supreme Court stated in this judgement that "should congress ultimately determine that predictability is unimportant in this area of the law, it can, of course, make per se rules inapplicable in some or all cases, and leave courts free to ramble through the wilds of economic theory in order to maintain a flexible approach".[33]

Occasionally, per se treatment may condemn a practice that, under a specific set of circumstances, might have survived a "rule of reason analyses". However, these "errors" are tolerated for the sake of business certainty and litigation efficiency.[34] Nonetheless, the cost of applying the per se standard principally involves the fact that some efficiency enhancing conduct will be automatically condemned. Not only does this result in present costs to industry and the public, but such condemnation may chill future business arrangements and the development of innovative business practices.[35]

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[28] Vakerics, § 1.03 (3), 1–15.

[29] Ackermann, pp. 10 et seqq.

[30] Hartley et al., p. 3; Schmidtchen, pp. 1 et seqq.

[31] Hartley et al., p. 3; Hellwig, p. 231.

[32] US Supreme Court, *United States v. Topco Associates, Inc*., 405 U.S. 596.609 n. 10 (1972). See also Carstensen and First, p. 171.

[33] US Supreme Court, *United States v. Topco Associates, Inc*., 405 U.S. 596.609 n. 10 (1972).

[34] Hartley et al., p. 4.

[35] Hartley et al., p. 4.

In *GTE Sylvania*,[36] the US Supreme Court explained the trade-off of this issue by stating that per se rules require the Court to make broad generalizations about the social utility of particular commercial practices. The probability that anticompetitive consequences will result from a practice and the severity of those consequences on the one side must be balanced against its pro-competitive consequences on the other side.

Cases that do not fit the generalization may arise, but a per se rule reflects the judgement that such cases are not sufficiently common or important to justify the time and expense necessary to identify them. Once established, per se rules tend to provide guidance to the business community, and to minimize the burdens on litigants and the judicial system of the more complex rule of reason trials.

14.3.3 Economic Assessment of Defences

Both economic analyses – towards objective justifications and towards efficiencies – must be integrated into a legal assessment of a single case. From a US perspective, by examining monopolization cases under Section 2 Sherman Act *Salop* and *Romaine* propose that there should be a direct examination of both the adverse impacts of the conduct in raising barriers to competition and the efficiency effects it may simultaneously bring about.[37] A court should then balance the two by avoiding the "all or nothing" character.[38]

The balance between anti-competitive and pro-competitive effects is the outcome of the application of the "rule of reason" approach under Section 1 of the Sherman Act: the likelihood and magnitude of cognisable efficiencies must be assessed along with the anticompetitive harms to determine the actual or likely overall effect on competition in the relevant market. The essential purpose is to determine whether the efficiencies would be sufficient to offset the potential harm, for example, by preventing price increases.[39]

From an economic point of view, an economic process is in general efficient when the greatest value possible is being generated at the lowest possible resource cost. One reason for this not occurring, is when wasteful production methods would make it possible to get more of the same output without increasing the existing level of inputs ("productive efficiency").[40]

Second, even when the production process is efficient, those same inputs might create more value if either the products produced were distributed to different consumers, who value them more, or the inputs were used for different, more highly

[36] US Supreme Court, *GTE Sylvania, Inc*., 433 U.S. 36, 50 n. 16 (1977).

[37] Salop and Romaine, pp. 650 et seq.

[38] Kauper, pp. 1623 et seqq. and pp. 1641 et seqq.

[39] Jones, p. 720.

[40] Goetz and McChesny, p. 11.

valued outputs or products ("allocative efficiency").[41] Thus, competitive rivalry serves to minimise production costs and to move resources out of declining markets and into those areas where the price system has signalled the need for greater production.[42]

The criteria of efficiencies are similar to the exemption conditions of Article 101 (3) TFEU.[43] The possibility of an exemption of Article 101 (1) TFEU, if the conditions of Article 101 (3) TFEU are met or in case the provisions of a block exemption regulation apply, is only valid for Article 101 TFEU – but not for cases of an abuse of a dominant position under Article 102 TFEU. The question is now whether the concept of Article 102 TFEU will change in the future through the increasing importance of defence possibilities.[44]

Furthermore, one could ask the question what would happen if certain behaviour has pro-competitive effects but also anticompetitive effects. In this case, both effects need to be balanced: if the behaviour has a substantial anticompetitive effect, it is illegal, whereas if the effects are ambiguous or pro-competitive, the behaviour is legal. In this context, the question arises who will balance this – the lawyer, who may not be able to assess the economic implications of either effects, or the economists, who may not have the legal understanding to take into account all other effects that are also important. As a general answer, the lawyer of the antitrust authority or the court should make this judgment, taking into consideration an economic analysis by economists who support the legal assessment.

Since there is no practical guidance on how to balance certain effects, this creates also further legal uncertainty. It may be well possible to criticize this balancing approach. It could be argued that the uncertainty that flows from a qualitative or subjective attempt to balance multiple factors make it difficult to predict the outcome of such cases, which have both effects.

14.3.4 New Ways of Assessing Economic Effects in EU Antitrust Law?

Change for Definition of Market Dominance?

The Discussion Paper recognizes the circumstance that market share as such is not always an indication for market dominance. It states that high market shares could be seen as an indication of market dominance.[45] But high market shares do not automatically lead to a dominant position.

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[41] Goetz and McChesny, p. 11.

[42] Areeda, pp. 45 et seq.

[43] Sufrin, pp. 933 et seqq.

[44] Schmidtchen, pp. 9 et seq.; Strohm, p. 113.

[45] European Commission, *Discussion Paper*, para. 31: "It is very likely that very high markets shares, which have been held for some time, indicate a dominant position. This would be the case

The Discussion Paper therefore states that, in the context of dominant companies, no single method of market definition is likely to be adequate by itself. This is because economic tests are normally based on the assumption that prevailing prices constitute the appropriate benchmark for the relevant market analysis; an assumption that often does not hold in Article 102 TFEU cases, since dominant companies will almost inevitably have raised their prices above the competitive level.[46]

According to the Discussion Paper it is therefore, necessary to rely on a variety of methods for checking the robustness of possible alternative market definitions. Relevant factors that influence the decision regarding a market dominant position are market power and market shares, the level of entry barriers faced by potential competitors and the market position of the buyer. This indicates a more effects-based approach instead of focusing on the "rule of thumb" of market shares only, which stands for the form-based approach.

Changes of Definition of Abusive Behaviour?

The Discussion Paper also recognizes economic thinking in the context of the assessment of abusive behaviour and also takes the potential economic effects of an economic behaviour into consideration. The Discussion Paper states that, in analysing the impact of exclusionary conduct by dominant firms, it is competition and not competitors as such that is to be protected from foreclosure of the market.

The Discussion Paper further explains that the purpose of Article 102 TFEU is not to protect competitors from a dominant firm's genuine competition (based on factors such as higher quality, novel products, innovation or better performance in general) but to ensure that competitors are able to expand in or enter the market and compete therein on the merits.

Case-by-Case Assessment?

The Discussion Paper seems to focus on an economically oriented application of European antitrust law. This would require a case-by-case assessment. For price-based alleged abuses, for example, the Discussion Paper states that it is necessary to evaluate whether a competitor who is as efficient as the dominant company can compete against the price schedule or rebate system of the dominant company.

The abuses analysed in detail include predatory pricing, single branding and rebates, tying, bundling, refusal to supply or license, and restraints in the after-market. The economic evaluation of these conducts requires indeed a case-by-case assessment.

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where an undertaking holds 50 % or more of the market, provided that rivals hold a much smaller share of the market."

[46] Joelson, p. 400.

Such a case-by-case assessment should take into account the fact that most business practices that are potentially exclusionary may also have pro-competitive effects. Since the objective of competition policy is not to protect competitors but to protect competition and increase welfare, economic analysis suggests undertaking the following four-step approach in order to find whether a firm has engaged into abusive practices.[47]

In a first step, it should be determined whether the firm in question is dominant, which means that it has considerable market power. If this is the case, in a second step it should be clarified whether the practice has possible anti-competitive effects, including the formulation of a coherent hypothesis about the strategy of the firm. Then, as a third step, it should be assessed whether there are possible pro-competitive efficiency effects of the practice at hand, and – in a fourth step – the anti- and pro-competitive effects should be balanced, that is, to carry out an assessment of the net effects on consumer (or total) welfare.[48]

14.4 Form-Based Approach Versus Effects-Based Approach

14.4.1 Benefits of a Form-Based Approach

Simplicity

The main advantages of a form-based approach are its simplicity, ease of administration, and accuracy.[49] There are clear criteria and "rules of thumb" that make it easy to come to a conclusion in a short and cost effective way – even if the outcome may not be justified for all cases. The reason for this can be seen in the fact of generalization, which creates rules for similar cases without taking into consideration that some cases may be different compared to others. An example for a clear form-based approach can be seen in the "rule of thumb" for assessing market dominance in the context of Article 102 TFEU, if only the market share decides whether a company is considered as market dominant.

But even in cases where a form-based approach is followed, it is sometimes not easy to give a precise statement on whether a firm is market dominant given the difficulties and the disputes with respect to market definition. If the focus for assessing market dominance is on the market share only, it is easy to handle once the relevant market is defined; but as long as the question remains on whether the relevant market has been defined correctly, this approach is also linked to uncertainty.[50]

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[47] Motta, p. 17.

[48] Motta, p. 17.

[49] Organisation for Economic Co-operation and Development, *Competition on the Merits*, p. 2.

[50] See for difficulties of this uncertainty in practice Seitz, 'Kartellverfahrensverordnung', pp. 71 et seqq.

The possibility should also be considered that per se rules could lead to firms making strategic responses that avoid the rules but still harm consumers. By focusing on per se rules, firms may circumvent antitrust law constraints by way of attempting to achieve the same end results through the use of different commercial practices. By focusing on the effects of such actions rather than on the form that these actions may take, an economic-based approach makes such an attempt more difficult.

Time- and Cost-Effectiveness

Case-by-case assessments may have to uncover specific details in every case and this could make them slow, unworkable, and unenforceable. A form-based approach also saves time, as no economic in-depth analysis is conducted.[51] Such an analysis requires data and market information as well as other empirical information. For this purpose any empirical analysis should be based on the maximum data possible.

However, given the complex nature of the real world, data is often not available in an ideal, ready-to-use form.[52] Since the form-based approach does not require an economic in-depth analysis and market information, this approach requires no or almost no market information and thus it is also cost-efficient.

Legal Certainty and Predictability

The effects-based approach may cause some issues for legal certainty when companies are assessing cases under Article 102 TFEU.[53] Even if the outcome may not be the right one, the form-based approach provides some sort of predictability, which creates legal certainty.[54]

The predictability under a form-based approach, however, could sometimes also lead to *ex ante*-prohibitions, which could restrict economic processes by hindering certain non-harmful business practices and thus preventing innovation and economic growth. For companies this may lead to a "business chilling effect". This chilling effect would clearly constitute a disadvantage of the form-based approach and this could outweigh the legal certainty benefit.

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[51] Organisation for Economic Co-operation and Development, *Competition on the Merits*, pp. 2 et seqq.

[52] Florian and Walker, pp. 320 et seqq.

[53] See Van den Bergh and Camesasca, p. 4; Schmidt, 'More Economic Approach', p. 877; Bune and Batchelor, pp. 22 et seqq.

[54] Schmidt, 'Suitability', pp. 408 et seq.

In addition, one could argue in favour of an effects-based approach that an economic-based approach needs not necessarily require a departure from established case law.[55] Thus, there should be a compromise to protect innovation and growth but also to grant some form of legal certainty. Because predictability and legal certainty could also be seen as a value as such – not only for lawyers who need to apply antitrust law, but also for the companies involved and this could also enhance innovation and economic growth.

14.4.2 Benefits of an Effects-Based Approach

Assessment of Each Individual Case on Its Merits

A clear advantage of the effects-based approach is the focus on the presence of anti-competitive effects that harm consumers and the examination of each specific case, based on sound economic facts.[56] The form-based approach does not allow consideration of economic effects of certain behaviour in a single case. Generally, it is based on formalistic and simplified criteria. This may lead to the result that different cases could be handled in the same way although they are different, especially with regards to their economic effects.

On the other side, the same type of conduct often can be either "normal competition" or "abusive competition", depending on the circumstances. In this context, one could argue that there is no obvious form-based way to assess whether behaviour constitutes competition on its' merits. To assess potentially abusive conduct in that manner could be prone to false positive and false negatives.[57] This constitutes a clear benefit to an effects-based approach.

Flexibility for Companies Concerned

An effects-based approach results in a more consistent treatment of practices, since any practice is assessed in terms of its economic outcome. Different practices leading to the same result may therefore, be subject to a comparable treatment. This guarantees that formalistic criteria do not unduly thwart pro-competitive strategies. This approach allows companies to find the best profit maximising strategy in a pro-competitive way.

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[55] Dethmers and Dodoo, pp. 537 et seq.

[56] Behrens, p. 97; Hildebrand, 'more economic approach', pp. 513 et seqq.; Immenga, p. 463; Albers, pp. 3 et seqq.

[57] Organisation for Economic Co-operation and Development, *Competition on Merits*, pp. 2 et seqq.

Better Consideration of Efficiencies

As seen above, an effects-based analysis takes the fact into consideration that many practices may have different effects under different circumstances, and that the same practice may distort competition in some cases but promote efficiency and innovation in others.[58] This may lead to the result that an assessment of each specific case may not be undertaken on the basis of the form that a particular business practice takes, but rather will be based on the analysis of the anti-competitive effects resulting by certain behaviour.

Thus, the form of the behaviour, e.g. price discrimination, predatory pricing, tying and bundling, is of less importance when considering only the effects, identifying a competitive harm and assessing whether the negative effects on consumers are potentially outweighed by efficiency gains.

This requires the analysis of business behaviour based on sound economics and supported by facts and empirical evidence. Efficiency arguments are, however, not static and must be seen in a dynamic context.[59] This needs to be taken into account when assessing efficiencies.

14.4.3 Conflicting Goals, Theories and Interests

General Remarks

There is a critical importance to economic analysis based on efficiency considerations. Economic efficiency is one of the most important purposes of antitrust law. But economic efficiency is not just static. It must also be taken into account that there may be other effects, which could be hard to predict.

Those other effects may have an influence on the economic efficiency and lead to the assumption that economic efficiency is rather dynamic than static. One of these other effects could be the purpose of antitrust law that is, for example, to preserve the competitive process, because competition itself will produce the most efficient allocation of resources. This leads to the assumption that competition as such should be preserved – even when if it is uncertain whether it will produce those efficiency results.

In this context, economic analysis illuminates the relationship between the different goals of competition policy and reveals that policy makers will not be able to escape from trade-offs in cases of conflicting goals. The efficiency goal and the consumer welfare goal are not perfectly consistent with each other.[60]

Under US antitrust law, for example, economic assessments are influenced by increasing consideration of "market reality" factors instead of focusing on the

[58] Bune and Batchelor, pp. 22 et seqq.

[59] Furse, p. 199.

[60] Van den Bergh and Camesasca, p. 6.

old-style antitrust enforcement, where market share analysis was predominant.[61] Thus, economic efficiency is influenced by other factors; so for example to preserve a de-concentrated industrial structure, to disperse economic power, to provide free access to markets, to foster individual economic freedom, to provide self-policing markets and thus reduce the need for governmental control, and to lessen inequalities in economic conditions.[62]

There are many – sometimes conflicting – goals and interests that have an impact on the assessment of a single case. These conflicting goals and interests can be summarized in four categories.

Categories of Conflicts

Conflicting Goals of Society

Conflicting Goals may arise from a social point of view. An economic analyst of an antitrust law case needs only to consider from the perspective of economic goals, e.g. efficiency or consumer welfare,[63] whereas political goals and social goals may also play a role in the legal assessment of the case. This results from the fact that the law is not only influenced by economic arguments, but needs also to be informed of social and political factors.

Conflicting Economic Theories and Models

As seen before, economic assessments are not generally based on one single model or theory only. Generally, an economic analysis is based on different models or theories and on corresponding assumptions. Since economic assessment is empirical work, this gives room for alternative interpretations and thus to different outcomes.

Conflicting Public Interests

Besides that, there are also conflicting public interests due to the variety of people with different claims on public interest. Individual costs and benefits are inherently subjective and personal, and it is not possible to sum up subjective evaluations of cost and benefit for various individuals in society and arrive at any meaningful aggregate.[64]

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[61] See Williamson, p. 314.

[62] Spivack, 'Chicago School Approach', p. 86; Spivack, 'Monopolization', pp. 304 et seqq.; Fox, p. 1140; Pitofsky, p. 1051.

[63] Williamson, pp. 315 et seqq. and 326 et seqq.

[64] Armentano, p. 10.

There may be no ways to calculate precisely the greatest good for the greatest number, or to determine the aggregate social costs associated with achieving any collective objective. However, the notion of consumer surplus – approximated by the area under the demand curve and above the price line – may be a good indication to aggregate the welfare of consumers.

Conflicting Objectives of Antitrust Law

Another conflict may arise from potential inconsistencies in the objectives of antitrust law. The emphasis on the market integration goal on EU antitrust law may lead to rules that are different from the US antitrust law.

In the EU, efficiency may be sacrificed for the objective of the internal market because the European integration has been seen as a goal in itself.[65] European competition authorities, however, will continue to come more in line with US antitrust law – and thus more favourable to pure economic arguments – as European economic integration reaches its stage of competition.[66]

14.5 Conclusion

Economic assessments based on models and empirical facts are only as good as competition authorities, courts and companies can understand and evaluate them. *Pablo* and *Walker* bringing this to the point by arguing that empirical analysis should be "transparent and accessible".[67]

If the authorities and courts cannot or do not appraise the evidence properly, then it is reasonable for them to disregard it.[68] Thus, good empirical analysis is an analysis which provides a correct description of reality and which is accessible to decision-making bodies.[69] This seems to be a good approach when considering ways to combine the form-based approach and the effects-based approach.

The question arises why is it only now that this idea of economic theory is not coming to threaten established legal precedent and procedures in antitrust law. The answer is that there has been a gap between the two disciplines in the past, and that both disciplines have not communicated adequately.[70] The change started with the thoughts of Chicago School and is increasingly relevant.[71]

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[65] Wessling, pp. 80 et seq; Sauter, p. 34; Neven, Papandropoulos and Seabright, p. 15.

[66] Van den Bergh and Camesasca, p. 6.

[67] Pablo and Walker, p. 320.

[68] Pablo and Walker, p. 320.

[69] Pablo and Walker, pp. 320 et seq.

[70] Shapiro, Bork and Breyer, p. 6.

[71] See Shapiro, Bork and Breyer, p. 7.

Thus, lawyers should use economics as a tool for analysing cases, for example by assessing cases of misuse of a dominant position or monopolization. There should be a compromise between the form-based – the "more legalistic approach" – and the effects-based – the "more economic approach". This could be achieved, for example, through the introduction of a generalized set of economic principles for standardized and similar cases.

On the other hand, there should be an in-depth economic analysis for exceptional and more complex cases. There the focus should clearly be on an effects-based approach. This would help lawyers handle the majority of cases on their own by taking economic thinking into consideration and asking economists for a specific economic analysis in exceptional cases.

This would lead to more economic-based approach of legal decisions in antitrust law cases and would combine the advantages of the form-based and the effects-based approach as shown in this paper. However, antitrust law is based on the principle that competition itself is the best mechanism for avoiding inefficiencies, therefore the competition authorities and the courts should not try to replace the role of competition in the market through their own assessment, which may be an intervention into competition.

In summary, if the question of a form-based or an effects-based approach is raised it should be the lawyer and not the economist who should make the final decision. Although antitrust law depends on economic assessment, it should not be the economist who makes the final decision decision in a specific case at the end. Economic analysis is often based on theoretical assumptions in a simplified world. Thus, economic solutions sometimes do not fit into a "second-best world".

Taking the consistency of judgements and the legal certainty into consideration, it also should not be the economist who determine, whether the decision is only based on welfare improvement, which is based on the latest economic theory. There is a certain value in having some "rules of thumb" that give a degree of predictability from the fact that decisions will come out the same each time until there is a basic change in the way a problem is handled.

Thus, in the end, it should be the lawyer who decides the case.[72] In "grey areas", where the economic literature and the economic advice are unclear or unpersuasive, a lawyer must still act and decide, also taking into consideration competing or complementary values – as described under the conflicting goals, theories and interests of this paper.

Finally, lawyers have to interpret, apply and adjust the interpretation of the law in a constantly changing business environment, taking into consideration new developments and questions. Thus, lawyers have to make a decision under changing economic theories and models, as well. However, decisions made by lawyers are only as good and valuable to competition as they are also taking into consideration economic thinking.

[72] Shapiro, Bork and Breyer, p. 9.

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