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INSTITUTIONAL LAW AND ECONOMICS

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Abstract

From its beginnings in the late nineteenth century, institutional economics has been concerned with the analysis of the interrelations between legal and economic processes. The institutional approach to law and economics examines both the influence of economy upon law and legal reasoning and the influence of law and legal change upon economic activity and performance. This essay examines the central tenants of institutional law and economics, dating from the early work of individuals such as Robert Lee Hale and John R. Commons and through its modern manifestations. As such, it emphasizes the evolutionary nature of law and economy, the tension between continuity and change, the problem of order, the reciprocal nature of legal-economic problems and the attendant dual nature of rights, the problematic nature of efficiency, and the need for a comparative institutional approach to the practice of law and economics. By recognizing the multiplicity of potential solutions to legal-economic problems and the underlying value premises attending each, the comparative institutional approach to law and economics attempts to flesh out both what is actually going on within the legal-economic nexus and the alternative possibilities open to society within the legal-economic decision-making process.

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1. Introduction

From its beginnings in the late nineteenth century, institutional economics has been concerned with the analysis of the interrelations between nominally legal and economic processes. The earliest roots of law and economics are in part within the institutionalist tradition of economics but, as recognized by Warren J. Samuels (1993), go well beyond that school of economic analysis. Early contributions to the institutional approach to law and economics include the work of Henry Carter Adams (1897) on economics and jurisprudence, Richard T. Ely (1914) on the relation of property and contract to the distribution of wealth, and, especially, John R. Commons (1924, 1925) on the legal foundations of the economic system. Important elements of the institutional approach to law and economics can also be found in the work of Thorstein Veblen (1899, 1904), lawyer-economists Robert Lee Hale (1952) and Walton H. Hamilton (1932), and legal scholars such as Karl Llewellyn (1925), Jerome Frank (1930), and Roscoe Pound (1911a, 1911b, 1912). Institutional economics is essentially an American contribution to economic thought, one that, like Legal Realism in jurisprudence, is said to have ‘had its heyday in the 1920s and early 1930s’ (Bell, 1967). Nonetheless, it continues to have a relatively strong presence today in both the US and Europe.

A. Institutional Economics

2. Overview

Institutional economics developed as a rather heterodox approach to the study of economic society and has been amply reviewed by Bell (1967, pp. 539-571), Gordon (1964, pp. 123-147), Kapp (1976), Mitchell (1937), Rutherford (1994), Spiegel (1971, pp. 628-641), Srivastava (1965, pp. 470-487), and more recently by Pribram (1983, pp. 355-62; 424-29) and Whalen (1996). There also are extensive overviews/anthologies of institutional economics including those by Hodgson, Samuels and Tool (1994), Samuels (1988), and Tool (1988, 1993). As its name implies, institutional economics places at the center of analysis the study of the institutions of the economic system. Institutions are variously and broadly defined within institutional economics. Commons (1934) defined an institution as ‘collective action in control of individual action’ and as ‘collective action in restraint, liberation, and expansion of individual action’ thereby emphasizing the social bases of the individual which orthodox economists took as given and self-subsistent. Veblen (1899) defined institutions as ‘widely followed habits of thought and the practices which prevail in any given period’, thereby emphasizing their problematic and

belief-oriented nature. Herbert J. Davenport essentially combined the two definitions in his description of an institution as 'a working consensus of human thought or habits - a generally-established attitude of mind and a generally-adopted custom of action as for example, private property, inheritance, government, taxation, competition, and credit' (cited in Srivastava, 1965, p. 470).

Institutional economics has often been described as part of 'a revolt against formalism' (Spiegel, 1971, p. 629), a revolt that took place in law, in history, and in economics at about the same time. Institutional economics, as part of that revolt, was led by a group of young American scholars who, after World War I, engaged in a critique of the predominate, formalistic economic doctrines of the day. In economics, formalism was taken to be the abstract *deductive* reasoning of orthodox economic analysis that enthroned universally valid reason, assumed passive, rational utility-maximizing behavior, and demonstrated an inordinate concern over the equilibria of comparative statics (in particular utility analysis of consumer behavior and the marginal productivity theory of distribution).

Reflecting their belief that this methodology was inadequate for understanding many important facets of the economic system, institutionalists focused their attention on *inductive* analyses of specific institutional aspects of the American economy. While their principal emphasis was on using the inductive method to describe the constituent elements of the economy, the institutionalists never employed the inductive method to extremes and thereby were still able to make substantive theoretical generalizations. As noted by Buckingham (1958, pp. 107-108), 'the development of generalizations gave institutional economics more of a theoretical content than the largely descriptive [German] historical school was ever able to attain. Institutional theory is by no means as refined and exact as orthodox theory, but is not so abstract and lacking in empirical content either'.

3. Factors Contributing to the Institutional School of Thought

Whalen (1996) has traced the emergence of institutional economics to three distinct sources of influence. One was the German historical school, which influenced such early institutionalist thinkers as Richard T. Ely. The German historical school, founded by Wilhelm Roscher (1817-94) and later dominated by Gustav von Schmoller (1838-1917), emerged at least in part as a reaction against classical economic thinking in the mid-nineteenth century. The historical school emphasized the dynamics of economic development, the need to use empirical data (rather than abstract ideas) to

ground economic theories, and the necessity of paying particular attention to human institutions. This emphasis on gathering facts and studying them in relation to their historical significance rather than as isolated, objective data in static, timeless models had a direct bearing on the methodology of emerging institutionalist economics.

The second influence was from American pragmatic philosophy as set forth by, among others, Charles Peirce, William James and John Dewey. Proponents of American pragmatic philosophy recognized an uncertainty inherent in understanding and looked for philosophical methods for establishing the meaning of concepts and beliefs. The analysis of social phenomena had to be conducted within systems of relationships among individuals in their empirical settings. They largely replaced *a priori* abstract reasoning with empirical studies. Contrary to the narrow, uniform 'rational behavior' assumption in orthodox microeconomics, choices were pragmatically perceived - to be made in a world of ever-changing empirical objects and emerging economic, political, and social institutions. 'True' ideas are those to which responsible investigators would assent after thorough examination - that is, after considering what conceivable effects of a practical kind a theory or object holds. Thus, only those hypotheses that contributed to organizing data garnered through sense perceptions related to the real world (that is, held practical significance), and did so in a progressive and unifying manner, were taken to be legitimate. In short, an idea was right if it had 'fruitful' consequences. The pragmatist emphasis on the uncertainty inherent in understanding served to provide an epistemological foundation and a social philosophy upon which to erect the basic tenets of institutional economic thought.

The third influence came through Thorstein Veblen's turn-of-the century writings focusing on the Darwinian, non-teleological evolutionary nature of economic change to which one can trace many of the origins of and early insights into institutional economic thought. After short sojourns at a variety of universities, including Johns Hopkins, a doctorate degree in philosophy from Yale University in 1884, and several years (1891-96) as an economics fellow at Cornell University and the University of Chicago, Veblen was given a teaching post at the University of Chicago in 1896, becoming an assistant professor of economics in 1900 at the age of 43. The previous year he published his first and most renowned book, *The Theory of the Leisure Class* (Veblen 1899).

Here, as in his other writings, Veblen emerged a strong critic of orthodox economic thinking, rejecting the mechanistic view of economic society as reflected in static equilibrium analysis. As observed by Spiegel (1971, pp. 631-632), Veblen rejected the orthodox 'hedonistic conception of man as a lightning calculator of pleasures and pain' as overly narrow and outmoded.

Consequently, he characterized the conventional approach to economics as taxonomic, overly concerned with classification and systematization that depicted human behavior in passive, inert, hedonic terms and, at the same time, brushed aside the 'disturbing factors' that did not fit into the received doctrine's pursuit of truth. With respect to conventional economics' pursuit of truth, in a revealing statement in an address in 1908, Veblen asserted that 'the outcome of any serious research can only be to make two questions grow where one question grew before' (Spiegel, 1971, pp. 631).

Veblen focused on what he called an evolutionary method of economic analysis. He believed that the material environment, technology, and propensities of human nature condition the emergence and growth of institutions. Because he believed that social change implied changes in habits of thought and customs as crystallized in institutions, he insisted on a critical examination of capitalistic institutions - especially what he termed *industry* and *business*, along with the economic power they were able to exercise - to better comprehend economic society. Toward that end, he emphasized that it was necessary to understand both the 'widespread social habits' and the institutions, and not merely how prevailing institutions worked, but with finding out how the institutions of capitalism evolved.

In another of his books, *The Theory of Business Enterprise* (1904), Veblen identifies the price system as the leading economic institution in the so-called pecuniary economy. Many contributing factors, most of which are inherent in the economic system including 'businesslike technicians', 'labor organizations', 'technological advances', and so on, lead to economic tensions among the interrelated forces of production and profit. These tensions manifested themselves in a class system - (1) the productive class, comprised of those who were socially productive, and (2) the leisure class, comprised of those who came to depend upon acquisition. And, as described by Bell (1967, pp. 548-549), these manifested themselves in 'custodians of absentee-credit' who were certain to engage in 'capitalistic sabotage' and further, that 'the struggle for economic advantage for their own vested interests' would result in both labor and business technicians engaging in a 'conscious withdrawal of efficiency'. 'Cultural lags' brought on by technological change altered the institutions and human behavior resulting in an ever-present class conflict (Srivastava, 1965, pp. 474-475). Thus, as Veblen described it, it is the very factors within the institution of the price system that led business to experience fewer intervals of short-term depressions that ultimately gave way to more chronic stagnation. For Veblen, the pecuniary aspects of life are all-pervading and become an integral part of the analysis of the evolution of society.

4. Modern Elements of Institutional Economics

From the writings of Thorstein Veblen and other contributors (to be reviewed below) such as Wesley C. Mitchell, Clarence E. Ayres, Walton H. Hamilton, Robert Lee Hale and John R. Commons, institutional economics emerged as a rather heterodox approach to analyzing economic society. As will become evident, many of the founders of and present contributors to institutional economics stress the evolutionary facet of institutions and, thus, the economy. This continuing concern with the evolutionary nature of the economy underlies the name of the association - The Association For Evolutionary Economics - that has maintained some intellectual continuity and focus among this group of economists. The Association publishes its own journal, the *Journal of Economic Issues*. The *Review of Political Economy* regularly publishes work embodying the institutionalist perspective (often with a somewhat more European flavor), as do the *Cambridge Journal of Economics, Economy and Society, Industrial and Corporate Change* and the *Review of International Political Economy*.

In its modern form institutional economics, as set forth by Gordon (1964, pp. 124-125), is embodied in a series of propositions defining an approach both alternative to and complementary to mainstream economic analysis. These propositions, together with the particular and specific focus contributed by Commons, provide the foundation upon which institutional law and economics rests.

1. Economic behavior is strongly conditioned by the institutional environment within which economic activity takes place and, simultaneously, economic behavior affects the structure of the institutional environment.
2. The mutual interaction between the institutions and the behavior of economic actors is an evolutionary process, hence the need for an 'evolutionary approach' to economics.
3. In analyzing the evolutionary processes contained therein, emphasis is directed to the role played by the conditions imposed by modern technology and the monetary institutions of modern, mixed-market capitalism.
4. Emphasis is centered upon conflicts within the economic sphere of society as opposed to harmonious order inherent within the cooperative, spontaneous, and unconscious free play of economic actors within the market.
5. There is a clear and present need to channel the conflicts inherent in economic relationships by structuring institutions to establish a mechanism of social control over economic activity.

6. Institutionalism requires an interdisciplinary approach calling on psychology, sociology, anthropology, and law to help understand the behavior of economic actors and thereby generate more accurate assumptions in describing their behavior.

These propositions offer a partial rejection of the mechanistic price-theoretic approach proffered by the more orthodox neoclassical microeconomics. The propositions are a manifestation of the institutionalist position that the framework of orthodox economic analysis does not allow it to get at certain fundamentally important features of economic activity.

Further, evolutionary institutional economics is proffered as being based on more 'realistic' behavioral assumptions derived from a broad array of social science knowledge and a fuller appreciation for and understanding of the institutions driving a mixed-market economy. This drive for realistic assumptions led the early institutionalists to extensive data-collection efforts. A pioneer in this regard, and a leading institutionalist, was Wesley C. Mitchell, a student of Veblen's at the University of Chicago. Mitchell spent most of his academic career at Columbia University (from 1913-1944). His book, *Business Cycles* (Mitchell, 1928) was his greatest research work. In it, he maintained that all institutions were subject to forces that brought about change in response to changing conditions and behavior. His concern was with the behavior of institutional factors which would provide a basis for generalizations; thus the need to produce the empirical evidence (statistical records and quantitative verification of change) that would thereby permit the development of more realistic theories of economic change (Bell, 1967, p. 565). The book was a historical description of the economic organizations of four countries (US, Germany, Great Britain and France) and of the pecuniary aspects of their economies. In his research he compiled all of the data necessary to recount the business cycle theories within each country. Mitchell demonstrated that trade cycles were not accidental disruptions in the economy but were instead systematic fluctuations brought on by the changing economic organization of the economy together with its changing culture. It should be noted in passing that in furtherance of this tradition Mitchell founded the National Bureau of Economic Research, which has become a major center for empirical work in economics. Mitchell succeeded in helping to expand the scope of economics beyond static equilibrium analysis thereby fulfilling his mission 'to explain at once the current working and the cumulative changing of economic processes' (Mitchell, 1914, p. 37).

B. Institutional Law and Economics: Origins and Development

5. Ayres and Hale

Because institutional economics has always been concerned with legal facets of the economy (that is the relationship between the law and the development and performance of the economy), there is no clear dividing line or simplistic transition between institutional economics and institutional law and economics. Thus, an understanding of the nature of the analyses and the concerns of the major contributors to institutional economics concomitantly provides an understanding and appreciation of the scope and content of present-day institutional law and economics. This and the next section are intended to help make this transition.

Certain of Thorstein Veblen's ideas described above were given further development by Clarence E. Ayres. Ayres received his PhD in philosophy from the University of Chicago in 1917 writing on the relationship between ethics and economics. He started his teaching career at Amherst College assisting the legal-economist, Walton H. Hamilton in his course, 'Social and Economic Institutions'. After brief sojourns at the University of Wisconsin and New York University, in 1930, his former colleague, Hamilton, was influential in urging Ayres to move to the University of Texas at Austin where he influenced a generation of institutionalist scholars.

Ayres's perspective on the economy is found in his treatise *The Theory of Economic Progress* (Ayres, 1944). As described by Breit (1973), it is a theoretical work that attempts to explain the forces that have shaped the economy, focusing on those factors that accelerated the economy's development as well as those that have impeded it. For Ayres, the challenge confronting economics is to 'devise new organizational forms, to pragmatically develop organizational arts to match, rather than contradict, our science and technology' (Breit, 1973, pp. 255-256).

Ayres saw human activity as reflective of two basic and ever-present forces: 'technological' behavior, a productive and progressive force, and 'ceremonial' behavior (as manifested in, for example, hierarchies, mores, culture and ideology), which is counterproductive and inhibits change, acting as a curb on technological progress. The central theme of this work is that an exponentially expanding and advancing 'technology' (defined broadly as all human activities involving the use of tools, and thus including both human and physical capital) is responsible for the enormous changes in the welfare of society. The focus is not so much on the individuals, but on technological progress as related to the advancement of the tools (that is, the objective instruments capable of being variously combined) and the role of technology in enhancing economic progress. Since the ceremonial

institutions resist change, he argued, progress is a function of the relative strength of these progressive and inhibiting forces, with the variance of their relative strengths helping to explain the differential rates of development across societies and cultures.

Robert Lee Hale received his LLB from Harvard University in 1909 and his PhD in economics from Columbia University in 1918. As recounted by Dorfman (1959), Samuels (1973) and Duxbury (1990, 1995), Hale initially held a joint appointment in the economics department and the law school at Columbia University and then moved to the law school on a full-time basis in 1928. His emphasis on the integration of economics and law was reflected both in his teaching - particularly his course on 'Legal Factors in Economic Society' - and in his writing, much of which dealt with the regulation of railroads and public utilities, fields in which an understanding of the interface between economics and law has always been fundamental. Hale wrote extensively on the legal and economic theory of rate-base valuation, as well as on the regulation of rate structure and level. His writings were instrumental in the adoption by the courts of the 'prudent investment' doctrine of valuation for public utilities (Dorfman, 1959, p. 161).

Hale is perhaps best described as a legal realist who drew upon the emerging tradition of institutionalism (Duxbury 1995, pp. 107-108). Consistent with the realists of the day, Hale's work was very much a challenge to and critique of the dominant tradition of *laissez-faire* capitalism. And, while Richard Posner (1995, p. 3) contends that the legal realists had little influence on the contemporary law and economics movement, he does allow that Hale 'anticipated some of the discoveries ... of law and economics' as we know it today.

Like John R. Commons (whose contributions will be reviewed below), Hale was influenced by Wesley H. Hohfeld's articulation of 'fundamental legal conceptions', which, in Hohfeld's mind, were the 'lowest common denominators of law' (Cotterrell, 1989, p. 88). Hale's paradigm was comprised of the concepts of voluntary freedom, volitional freedom, coercion, power and government. Legal and economic processes were viewed as inseparable and the economy described as a structure of coercive power arrangements and relationships which necessitated an understanding of the formation and structure of the underlying distribution of economic power. As such, the economy was seen as a system of power operating through a system of coercion, and thus the economic freedom expressed by the courts of the day was merely freedom to engage in economic coercion (Samuels, 1973).

Hale did not view coercion as something to be condemned, but rather as a basic fact of economic life. For example, he argued that if income is in fact acquired through coercion, abetted actively or passively by government, then it cannot be said that overt coercive redistributions of income by government

are themselves wrong (Dorfman, 1959, pp. 162-163). Hale's Hohfeldian perspective on rights led him to view nearly every statute with economic implications as impacting negatively upon someone's liberty or property. Given this, he believed that it was essential for the courts to undertake an intelligent balancing of the gains and losses brought about by the particular statutes brought before them - a process which, he said, requires 'a realistic understanding of the economic effect of the legislation' (quoted in Dorfman, 1959, p. 163). While Hale believed that ethical judgments must ultimately be the basis upon which the court's decisions are made, he felt that the judicial application of economic principles was necessary in order to ascertain the economic consequences - allocative and distributive - of the legislation whose constitutionality the court was asked to evaluate (Hale, 1924, 1927). Hale's brand of legal economics - as reflected in both his writing and his teaching - gradually evolved into a 'theory of the economy as a system of mutual coercion and the legal basis thereof' (Samuels, 1973, p. 25), with his perspective being most fully spelled out in his classic book *Freedom Through Law* (Hale, 1952).

6. John R. Commons and his Impact on the Development of Institutional Law and Economics

John R. Commons stands as the central figure in the development of the institutional approach to law and economics. Unlike his contemporaries, Commons never earned a PhD degree and after a slowly developing academic career, in 1904, at the age of 42, he was given an appointment at the University of Wisconsin where he and his associates quickly brought the economics department to the forefront of the discipline (Spiegel, 1971, p. 630).

Commons became associated with the progressive government of the State of Wisconsin, engaging in what he termed 'investigational economics' (preparatory fact-finding reports produced by Commons and his students) necessary for the drafting of legislation and the formulation of innovative policies in a wide variety of areas including industrial relations, labor law reform (including workmen's compensation and unemployment insurance), public utility regulation and price stabilization. Besides teaching and writing at the University of Wisconsin, he was also very involved in public life serving on an array of state and federal commissions. In his distinguished academic career, Commons wrote several books, two of which now serve as a benchmark for institutional law and economics: *Legal Foundations of Capitalism* (Commons, 1924) and *Institutional Economics: Its Place in Political Economy* (Commons, 1934).

As Spiegel (1971, pp. 628-629) has pointed out, there was a pronounced linkage between Commons' institutional economics and the German historical school (due in part to his teacher Ely's attachment to the German school). The influence of the American pragmatic philosophers on his thinking was much less significant, although its presence is evidenced in his emphasis on the pragmatic importance of using inductive analysis. And unlike Thorstein Veblen, who sought a near total rejection of orthodox economic theory, Commons (as well as Wesley C. Mitchell) held a much more conciliatory position seeing institutional economics as a complement to, rather than a substitute for, neoclassical analysis.

Commons' institutional economics was conceived as a broad synthesis of law, economics and ethics; it recognized both conflicts of interest and their mutual dependencies as well as the need for security of expectations and order (Spiegel, 1971, p. 638). In contrast to the strict methodological individualism and the harmony of interests paradigm that imbued orthodox economics, Commons placed a greater emphasis on the role of collective and corporate activities in the economy and centered his analysis on the conflicts of interest inherent in a modern economy. Human action was seen to be socially or culturally determined; that is, human action and cultural determinants were seen to interact with each other. Consequently, the free will of individuals contributes to the cultural environment and is, in turn, molded by that environment (Buckingham, 1958, p. 104).

As characterized by Parsons (1957, p. 23), for Commons, the main task of economics consisted of determining the 'reasonableness of the working rules underlying the general economic order in an age in which citizens, corporations, and labor unions have economic power' (see also Parsons, 1985). Institutional economics for Commons was an economics of rights, duties, liberties and exposures and he looked at the economy as a series of intended and purposeful changes - so-called 'managed equilibria'. He believed that the primary economic institutions were formed on the basis of definite patterns of socially sanctioned habits and could be reshaped. This belief led him to probe extensively the impact of institutions, particularly the operation of the legal system (including the judiciary, the legislature and the regulatory commissions) in working out solutions to conflicts and the impact of those solutions on economic structure and performance.

In *Legal Foundations of Capitalism* (Commons, 1924) Commons's chief concern was with uncovering the development, evolution and workings of the institutions that ultimately impact the performance of the economic system. It was a theoretical work that examined the legal foundations of the capitalist economic system. The treatise was unlike anything that had come before and benefited from Commons's close contact with law through his extensive aforementioned involvement with the courts, his service on

government commissions and his drafting of legislation. The emphasis of the book is on the role of law and the courts and how they determine the structural elements of an economic system. Like his predecessors, Commons believed all economic institutions are subject to evolution. Whether describing the institution of capitalism, private property, or the state itself, each was shown to receive its sanction from the authorities - the church, the state, the courts - through an evolutionary process.

Commons analysis showed, on the one hand, how economy influences law as the economic system brings to bear pressures on political and legal systems for legal change that facilitates a particular evolutionary path and, on the other hand, how law influences the economy - that is, how legal change facilitates the development of economic activity in a particular direction. In order to bring out the nature and extent of this mutual interdependence, he undertook an analysis of a wide variety of cases, working rules and statutes to probe their impacts on the development of modern capitalism and thereby to illuminate the interrelations between legal and economic processes. Of particular import here is his analysis of the role played by rights and working rules within the economic system, where he lays out, in a systematic way, why rights (and thus law) matter within the economic system and why the development of economic theory should proceed with attention to the role of law and legal change in structuring economic activity and performance.

Commons was particularly concerned in *Legal Foundations* to uncover the values both underlying and enshrined in the working rules that govern social-economic relations. He found them in the courts' use of the term 'reasonable value' - whether reasonable value in public utility regulation, the reasonable wage in labor law, the reasonable safety as related to workmen's compensation, or the reasonable conduct of private and public citizens. He observed that legal history demonstrated certain well-defined tendencies on the part of the courts to eliminate those practices of capitalistic institutions deemed destructive, while at the same time to reaffirm the 'reasonable' policies that should be encouraged and followed in a competitive system. Determinations have to be made as to whose interests are to count or, said another way, to determine whose preferred practices would be given protected status. 'Reasonable value' could be used by the courts to ground policies that would bring about compromises in arenas of economic conflict, including labor disputes, public utility rate-making, tax policy, pricing, and so on (Bell, 1967, pp. 556-557). As the definition of what types of activities were considered reasonable evolved over time, so too did the legal rules governing social-economic relations, the structure of markets and the structure of capitalism itself, as seen in the effects of the transformation of the legal definition of property and its impact on business and the effects of law on the employment relation within the firm, on the market mechanism

and on the wage bargain. Thus, in the West, a movement was engendered from a feudal and agrarian society to a capitalist system, with economic change driving legal change, which in turn facilitated the economic transformations. (See Samuels (1996) for a 'Reader's Guide' to the *Legal Foundations of Capitalism*.)

7. Contemporary Institutional Law and Economics: The Commons Tradition

Virtually all of contemporary institutional law and economics follows in the tradition of Commons and much of this emanates from Michigan State University through the work of Warren J. Samuels and A. Allan Schmid, both trained at the University of Wisconsin by students of Commons. Others at Michigan State University who continue to contribute to this tradition are Harry Trebing, whose works exhibit many of the same concerns as Hale with regard to the analysis of regulation and public utilities (Trebing, 1976, 1989; Trebing and Estabrooks, 1993); and Robert A. Solo, much of whose work focuses on monopoly regulation and institutional change (Solo, 1967, 1974, 1982). Former students of Samuels and Schmid who have gone on to focus their research on the relations between legal (or governmental) and economic processes rather than the application of microeconomic theory to the law, include Steven G. Medema and Nicholas Mercuro writing individually and together on topics including the Coase theorem (Medema, 1994, 1996a; Medema and Zerbe, 1997), the policy implications of Coasean economics (Medema and Samuels, 1997), the commonalities between the work of the Institutionalists and the work of Coase (Medema, 1996b), law, economics and public policy (Mercuro and Ryan, 1984), the comparative institutional approach to law and economics (Mercuro, 1989b) and on the various schools of thought comprising law and economics, including the institutionalist school (Mercuro, 1989a; Mercuro and Medema, 1995, 1997); Philip Wandschneider (1984, 1986) on water rights; and Josef Broder (1981, 1983) on the judicial process.

Other examples of the institutional approach to law and economics can be found in Bromley (1989), Carter (1985), Kanal (1985), Liebhafsky (1987), Ostrom (1986), Parsons (1974), and Seidman (1973).

Much, though not all, of the work of A. Allan Schmid and Warren J. Samuels (see the extensive references to their respective work at the end of

this essay) can be best understood in the context of the structure-conduct-performance paradigm:

$\hat{\Gamma}$ law or legal structure \vee $\hat{\Gamma}$ behaviour or conduct in the mixed market economy \vee $\hat{\Gamma}$ economic performance

For institutional law and economics, the emphasis is on the interrelations and *mutual* interaction between government and the economy, with the effect that its perspective is described by the relation

$\hat{\Gamma}$ law or legal structure] $\hat{\Gamma}$ behaviour or conduct in the mixed market economy] $\hat{\Gamma}$ economic performance

Both Samuels's and Schmid's practices of institutional law and economics are avowedly positive. As they describe it in the 'introduction' to their book on institutional law and economics (Samuels and Schmid 1981, p. 1), 'Our principal goal is quite simply to understand what is going on - to identify the instrumental variables and fundamental issues and processes - in the operation of legal institutions of economic significance' and to promote 'the development of skills with which to analyze and predict the performance consequences of alternative institutional designs'. The focus of their institutional approach is on delving into the workings of the legal-economic nexus in order to understand its processes and thereby analyze the processes and consequences of choice. Resource allocation and the distribution of income and wealth are explained 'in terms of a complex causal chain involving both allocation and distribution as functions of market forces that depend in turn on power, rights and the use of government' (Samuels and Schmid, 1981, p. 4).

Samuels and Schmid's respective approaches are best understood as two complementary branches that differ only with respect to the relative emphasis given to 'structure' and 'conduct'. The work of Schmid has tended to concentrate on the interdependence of structure and performance, with an emphasis on empirical work that explores the economic impact of alternative legal structures. A concise statement of Schmid's approach to institutional law and economics is contained in his book *Property, Power and Public Choice: An Inquiry Into Law and Economics* (Schmid, 1987), which includes examples of empirical studies undertaken by Schmid (see Schmid, 1987, pp. 257-291). In his approach, he brings to the forefront the many varieties of human interdependence, focusing both on (1) the various types of transactions - bargained, administrative and status and grant transactions and (2) the varied interdependencies that emerge - technological, pecuniary and political externalities. Schmid's analysis takes place under a

situation-specific structure-conduct-performance paradigm, in which alternative institutional structures (for example, different definitions and assignments of property rights) are identified, together with the (dis)incentives created, their consequences for individuals, firms and government behavior are identified and their effects on economic performance and quality of life are assessed. As such, it reflects a 'total' approach to policy analysis (Schmid, 1987, pp. 257-258), one that emphasizes the link between structure and performance. As posed by Schmid (1987, p. 188), the institutional approach to law and economics must ask: How do the rules of property structure human relationships and affect participation in decisions when interests conflict or when shared objectives are to be implemented? How do the results affect performance of the economy?

The work of Samuels, in contrast, has tended to concentrate on describing the interdependence between conduct/behavior of individuals and groups and legal-economic performance. For Samuels, the organizing concept is that of the legal-economic nexus, wherein 'the law is a function of the economy and the economy (especially its structure) is a function of law ... [Law and economy] are jointly produced, not independently given and not merely interacting' Samuels (1989a, p. 1567). Through the legal-economic nexus are worked out the structures of the law and the economic system, where each serves as both dependent and independent variable in the construction of legal-economic reality. Legal rules govern 'the terms of access to and participation in the economy by potential economic actors' and 'property and other rights ... govern whose preferences will be given effect through the market' (Samuels, 1975, p. 66).

C. Central Themes of Institutional Law and Economics

8. The Evolutionary Nature of Law and Economy

As noted above, one of the factors emphasized by the institutionalists and especially John R. Commons in his discussion of the legal foundations of the capitalist economic system is the evolutionary nature of the economic system. The import of the evolutionary perspective is that it broadens the frame of analysis beyond the 'idea of mechanistic maximization under static constraints' (Hodgson, 1994, p. 223) to the longer-run processes (gradual or in leaps) of economic development - structural transformations owing to technical, legal, or other forces, knowledge acquisition, and so on. While not eschewing static analysis or denying its value, the role of legal change in affecting the course of this evolution makes the institutional approach to law

and economics inherently evolutionary, as exemplified in Commons' analysis and in particular in his discussion of the evolution of the law of property.

Prior to the late nineteenth century, the US courts held to a physical conception of property, a view that defined property as value in use rather than value in exchange (Commons, 1924, p. 12). One of the implications of this definition of property was that governmental deprivations of exchange value did not require compensation under the Fifth and Fourteenth amendments. As Commons (1924, pp. 12-14) points out, it was only in the 1870s that the idea of property as value in exchange first began to creep into dissenting opinions of the US Supreme Court and it was not until the 1890s that the Court finally made the transition from a definition of property as a thing having only use value to a definition that conceived of property as the exchange value of something. In making this transition, the Court was saying not only that physical things are property, but that 'the *expected earning power* of those things is property' and thus '[t]o deprive the owners of the *exchange value* of their property is equivalent to depriving them of their property' (Commons, 1924, p. 16, emphasis in original). No longer were physical seizures of property the only 'takings' requiring compensation; it now became the case that activities (including government regulations) that reduced the exchange value of things could give rise to claims for compensation. The concept of property was further expanded in the *Allgeyer* case of 1897 to include liberty of access to markets, an important component in the determination of exchange values (Commons, 1924, p. 17). The received definition of property as corporeal property had been expanded to include both incorporeal property - for example, debt instruments or promises to pay - and intangible property - 'anything that enables one to obtain from others an income in the process of buying and selling, borrowing and lending, hiring and hiring out, renting and leasing, in any of the transactions of the modern business' (Commons, 1924, p. 19).

The import of this expanded definition of property for the development of the capitalist system is set forth by Commons in the context of farming:

The isolated, colonial or frontier farmer might produce and consume things, attentive only to their use value, but the modern farmer lives by producing 'social-use-values' and buying other social-use-values produced and sold by other business men. In this way he also 'produces' exchange-value, that is, assets. He farms for sale, not for use and while he has the doubtful alternative of falling back on his own natural resources if he cannot sell his products, yet his farm and crops are valuable because they are business assets, that is, exchange-values, while his liabilities are his debts and his taxes, all of them measured by his expectations and realizations on the commodity markets and money markets, in terms of exchange-value or price. (Commons, 1924, p. 21)

That is, what in part distinguishes capitalism from the colonial and feudal systems it replaced is the transition from production for one's own use to 'production for the use of others and acquisition for the use of self' (Commons, 1924, p. 21) and it was the adoption of this more expansive definition of property that helped to facilitate this economic transition.

Following Commons, the contemporary institutional approach to law and economics is evolutionary, emphasizing the importance of historical process and evolutionary change of law through time. As described by Samuels (1989a, p. 1578), the legal-economic nexus 'is a continuing, explorative and emergent process through which are worked out ongoing solutions to legal problems'. The legal-economic nexus is that sphere of decision making that reflects the working out of whose interests are to count as rights, whose values are to dominate and who is to make these decisions. The resolution of these issues determines not just rights, but the allocation and distribution of resources in society and hence power, income and wealth. The structure of legal-economic institutions - the state (whether in the context of the legislature, the bureaucracy, or the judiciary), the firm and the market - channels legal-economic decision making and this structure is seen as the outcome of an evolutionary process of legal-economic change rather than as movement to a steady-state equilibrium (Schmid, 1989, p. 66). Legal change, while gradual, has been continuous and 'has led to major transformations of the legal system and of the pattern of rights and, thereby, of the system of economic organization and control' (Samuels and Mercurio, 1979, p. 167). The pervasiveness of legal change and the ongoing process of legal-economic reconstruction through the nexus process thus makes necessary an evolutionary-historical approach that accounts for the array of factors and forces promoting both continuity and change over time. Illustrative examples of this type of analysis are provided by Field (1979, 1981, 1984, 1991) and Bromley (1989).

Field (1979, 1984) argues that a meaningful analysis and explanation of rules structures that organize and regulate economic activity cannot be accomplished by incorporating the rules into an endogenous neoclassical model. Rather, he asserts, a thorough understanding of the determinants and consequences of institutions and rules requires a case-by-case approach that maintains particular sensitivities to the historical, cultural and legal facets of the particular legal-economic institution being studied, including the norms that influence legal-economic behavior. In an analysis critical both of Chicago law and economics and of neoinstitutionalist law and economics (particularly the works of Posner and North and Thomas), Field (1981) asserted that some subset of institutional structures needs to be treated as parametric in the general equilibrium models and granted an explanatory status analogous to that traditionally accorded tastes, technology and

endowments in the neoclassical model. More recently, Field (1991) has urged that legal-economic scholars devote more extensive attention to the effects of legal rules (particularly through income-expenditure effects) on aggregate or macroeconomic variables.

Bromley (1989), too, criticizes the narrowness of the Chicago and neoinstitutional (or new institutional) models of institutional change - particularly their contention that institutional change is driven solely by considerations of efficiency. Against this, he presents an analysis of institutional change that makes such change hinge on four factors: (1) the alteration of the economy's productive efficiency, (2) the redistribution of income, (3) the reallocation of economic opportunity and (4) the reallocation of economic advantage - all worked out over time in the context of individuals and collectivities pursuing their interest within a larger social-political context.

9. Continuity versus Change

The recognition of the evolutionary nature of legal-economic relations brings to the fore a second fundamental theme of institutional law and economics: the ever-present tension between continuity and change in legal-economic relations. The evolutionary path of the legal-economic system is derivative of the legal-economic policy *choices* that are made over time. Continuity and change are the outcome of the policymaking process, more specifically, of the interaction between the groups supporting the respective forces of continuity and change and the power that each can bring to bear on this process (Samuels, 1966, pp. 267-273). Within this policymaking process (be it legislative, bureaucratic, or judicial) arise and operate forces that, through acts of commission or omission, serve to maintain the *status quo* structure of legal-economic institutions and relations - that is, continuity - while other forces promote an alteration in these institutions and relations - that is, change. The ongoing choice process within the legal-economic arena determines both the institutional structures that obtain at any given point in time and whether the *status quo* institutional structures, or some other, will prevail in the future, that is, whether there will be change and if so how much.

10. Mutual Interdependence, Conflict and the Problem of Order

Institutional law and economics views the legal-economic system as a system of mutual interdependence rather than one of atomistic independence. The economy, says Schmid (1989, p. 59), is 'a universe of human relations', not merely 'a universe of commodities' and within this

world each individual has scarcity relationships with others. While it may be that part of life deals with movements from positions off of contract curves to positions on contract curves in the process of exhausting gains from trade, the institutionalist approach places strong emphasis on (1) who gets to play, (2) where one starts in the game and (3) the rules governing the game.

Given the importance of human interdependence and the emphasis on who plays and what are the starting points, the focus of institutional law and economics is on conflict rather than harmony, where '[t]he role of the legal system, including both common and constitutional law, is to provide a framework or a process for conflict resolution and the development of legal rights' (Samuels and Mercuro, 1979, p. 166). The fundamental problem here is that of order, which Samuels (1972a, p. 584) defines as 'the reconciling of freedom and control, or autonomy and coordination including hierarchy and equality, with continuity and change'. 'The ultimate meaning of the legal and economic processes' says Samuels (1971, p. 449), 'is in terms of their functioning toward resolving the problem(s) of order'. The existence of conflicting interests necessitates both a process (or processes) for deciding between these competing interests and a method (or methods) for determining how these conflicts are to be resolved.

At the micro level, the firm is seen as something more than a nexus of contracts among isolated individual agents. It is a community designed in part to suspend narrow, individualistic calculations of advantage and facilitate the learning of standard objectives. This is more fully explored by Hodgson (1988), Eisenberg (1990), Lazonick (1991) and Leibenstein (1987), who focus not only on the social origins of individual preferences and goals but on the complex processes by which individual utility functions are constructed and revised and by which the meaning of 'profit maximization' is worked out by agents within the firm. Present within this and other literature is a rich array of analyses of individual psychology, going beyond the simplistic rationality assumption; of organizations, going beyond their treatment as homogeneous, predetermined entities; of behavior in general, going beyond the singular focus on isolated individuals to the institutional and organizational environment in which they operate; and so on. Among the sources of these analyses are modern Darwinian evolutionary theory, cognitive psychology, organization theory and comparative economic systems. Some of the analyses can appear to be either extensions of or departures from neoclassical economic theory, while other analyses are intended to be alternatives to mainstream economics. One result is the showing that the unique determinate optimal equilibrium solutions of the neoclassical research protocol are both presumptive and forced, heuristically

useful for analytical exercises but not representative of actual economic processes in all their evolutionary complexity.

In all this, society is recognized, at least in part, as a cooperative venture for mutual advantage where there are both identities and conflicts of interests in ongoing human relations. Within this system of mutual interdependence, societal institutions, including the legal system, both enhance the scope of cooperative endeavors and channel political-legal-economic conflict toward resolution (Mercurio, 1989b, p. 2). The resolution of these conflicts, of whose interests government will give effect through law and otherwise, is the resolution of the problem of order in society - a working out of a societal structure that promotes coherence, security and orderliness in human relations. Indeed, the manner by which a society comes to channel conflict says much about its ultimate character.

11. Rights, Power and Government

Law is fundamentally a matter of rights creation and recreation. Consistent with the positive, descriptive nature of their approach, institutionalists are concerned with the rights (re)creation process and the impact of this process on legal-economic decision making and activity. To understand the importance of rights from the institutional perspective, it is first necessary to understand the sphere of activities open to individuals and the institutionalist conception of the determination of the individual choice process.

Individual decision making is a function of one's opportunity set, which 'consists of the available alternatives for action or choice, each with a relative opportunity cost, which are open to the individual' (Samuels, 1974, p. 120). However, these opportunity sets are limited in their scope: owing to human interdependence and scarcity, each individual's opportunity set is constrained and shaped by the opportunity sets of others in society. Since each individual desires to make choices from a set that is as unconstrained as possible, individuals will wish to control the choices and hence opportunity sets, of others who may constrain their choice. The extent of each individual's ability to determine his or her own choices and to influence the opportunity sets and hence choices, of others is the outcome of a process of mutual coercion, where the ability to coerce is simply the ability of A to impact B's opportunity set without B's consent. An individual's capacity to exercise coercion is, in turn, a function of that individual's power, defined as 'the means or capacity with which to exercise choice' and this power is relative to the power of others. Thus, '[t]he opportunity set of the individual, within which he attempts a constrained maximizing

equilibrium, is a function of the total structure of mutual coercion, grounded upon relative power'. Moreover, power is also a dependent variable in this process, being a function of the choices made from opportunity sets that exist and evolve through time (Samuels, 1972b, pp. 65-66). Opportunity sets, then, are endogenously worked out rather than being exogenously given.

The ongoing attempts to delineate and redefine opportunity sets, through the machinations of power and mutual coercion in the face of conflicts, give rise to disputes which necessitate resolution. For example, the upstream polluting factory's choice of production technology impacts and conflicts with the choice of activities of the downstream water user and conversely. The upstream user cannot exercise choice without impacting the choice of downstream users and conversely. The resolution of such conflicts comes through the creation and assignment (or reassignment) of legal rights, which define the scope of choices open to each individual and the degree to which each is exposed to the choices of others. Thus, power and hence coercion and the resulting opportunity sets and choices, are a function of rights.

The origin of rights, as well as the (re)defining and the (re)assigning of rights through the resolution of conflicts of interest bring to the fore the point that rights have a dual nature - 'the opportunity set enhancement of those who have rights and the opportunity set restriction of those who are exposed to them' (Samuels, 1974, p. 122). Virtually every legal change imposes both benefits and costs, the enhancement of some opportunity sets and the simultaneous restriction of others. Externalities are thus ubiquitous and reciprocal - any (re)definition, (re)assignment, or change in the degree of enforcement of rights benefits some interests and harms others; the externality remains in different form; it is merely shifted, as was made clear by Ronald Coase in 'The Problem of Social Cost', (1960). From the institutionalist perspective, systems of property, tort and contract law, then, do not provide solutions to situations of externality but rather only resolutions, as externalities and hence benefit and harm are channeled in a particular direction through the legal delimitation of rights.

Government is seen to play a central and inevitable role within this process, for rights are not rights because they are preexisting, but rather are rights because they are protected by government. As Warren J. Samuels has written, 'Rights are whatever interests government protects vis-à-vis other interests when there is a conflict' (Samuels, 1974, pp. 118-119, 127). Rights are thus relative to and contingent upon 'the legal limitations inherent in their identification and interpretation, the exercise by others of their rights and legal and nonlegal change' (Samuels, 1974, p. 118). Each of these factors is a function of the rights-creation (and re-creation) process and hence of the ability of individuals to secure rights (or a change therein) through the use and control of government. Government thus becomes an

object of control for those seeking private legal-economic gain or advantage, 'a mode through which relative rights and therefore relative market (income securing) status is given effect' (Samuels, 1971, pp. 441-442). The question is not, then, one of more versus less government, but rather of whose interests government gives effect to through law - that is, through the process of rights creation and recreation. Contributors to institutional law and economics thus see terms such as regulation, deregulation and government intervention as misleading, in that government is omnipresent. For example, it is often said that the adoption of workplace safety regulations constitutes an intervention of government into the market, yet such activity represents merely a change of the interests to which government gives effect, as rights - a movement which expands the rights/opportunity sets of workers and reduces the rights/opportunity sets of employers. The issue as to who will have rights thus turns on whose interests government allows to be realized and who is able to use government for what ends. The critical matter is who is able to control and use the legal-economic nexus in order to control legal-economic continuity or change (Samuels, 1971, p. 440; Samuels, 1989a, p. 1578).

The central implication of the reciprocal nature of externalities is that the decision over whose interests are protected as rights is necessarily a function of a choice process - choice as to who will have rights and who will be exposed to the exercise of those rights, of who will be able to inflict gains and losses on others and to what extent (Samuels and Mercurio, 1979, pp. 172-174). This inevitable necessity of choice reveals that law is not something that is given or to be discovered, but is instead a human artifact marked by deliberative and nondeliberative human choice (Samuels, 1981, p. 168). The fact that law is a human choice process means that value judgments will necessarily be introduced in choosing between competing interests and legal-economic outcomes are thus 'an expression of the values of those who have participated and prevailed at each stage of choice in the political-legal-economic arena' - that is, those who are able to most effectively use government to further their own ends (Mercurio, 1989b, p. 10). Justice, then, reflects not some given set of high foundational principles, but rather a normative valuational process that determines the laws, norms and values that are to govern living (Samuels, 1971, p. 444; Samuels and Mercurio, 1979, pp. 160-163).

12. The Problematic Nature of Efficiency

Institutional law and economics has, on occasion, been characterized as rejecting outright Chicago law and economics. This is not so. Indeed while the institutional law and economics literature has been quite critical of

certain facets of the Chicago approach, Samuels (1981, pp. 148-149), for one, has praised Posner for the usefulness of his analysis in once again bringing to the attention of economists and legal scholars alike how economic conditions affect the law and conversely. Nonetheless, one of the hallmarks of the institutional approach to law and economics is the rejection of the Chicago and general neoclassical emphasis on the determination of *the* efficient resolution of legal disputes. The institutionalists do not reject efficiency as an important variable in legal-economic analysis, but rather maintain that efficiency alone cannot and should not, determine the assignment of rights (Samuels, 1989a, p. 1563).

The starting point for the institutionalist critique of the efficiency criterion is the recognition that economic activity - prices, costs, outputs, risk, income, wealth, and so on - is not some sort of natural phenomenon, but rather is determined by the structure of rights that exists in society, with the levels of and changes in each of these variables being in part a function of the legal structure and legal change over time (Samuels, 1971, p. 440, 1989a, p. 1565; and Schmid 1989, p. 67). Each particular rights structure will give rise to a particular set of prices, costs, outputs, and so on and thus to a particular efficient allocation of resources. Hence, there is no unique efficient result. For the institutionalists, the purportedly positivist Chicago-school rhetoric of 'atomistic industries' or 'contestable markets' and the associated concept of 'price-taking behavior' is exposed as nothing more than deeply normative 'rights-taking behavior' (Samuels and Mercurio, 1984). The institutionalists maintain that inasmuch as rights underlie product prices and thus costs, to talk of 'price-takers' bypasses virtually all that is (or should be) important in Chicago law and economics and much of public choice theory.

Because efficiency is a function of rights and not the other way around, it is circular to maintain that efficiency alone can determine rights. Since costs, prices, outputs, wealth and so on are derivative of a particular rights structure, so too are cost minimization, value-of-output maximization and wealth maximization. (For a detailed examination of the determination of costs in this regard, see Samuels and Schmid, 1997.) Different specifications of rights will lead to different (and economically noncomparable) minimizing or maximizing valuations. The result is that an outcome that is claimed to be efficient is efficient only with regard to the assumed initial structure of rights (Schmid, 1989, pp. 68-69) the latter of which is often the very matter at issue. Thus, as Samuels (1981, p. 154) asserts, '[t]o argue that wealth maximization [or any other efficiency criterion] can determine rights serves only to mask a choice of which interests to protect as rights. Legal decisions or changes can be said to be efficient only from the point of view of the party whose interests are given effect through the identification and assignment of rights.'

Moreover, the definition of 'output' - of what it is that one is to be efficient about - requires an antecedent normative specification as to the appropriate performance goal for society. Social output (the aggregate well-being of society), consumptive output (the value of goods from the consumer point of view) and productive output (the value of goods from the producer point of view, that is, profits) are three examples of the alternatives that are available. The value-laden choice of a particular definition of output as the maximand, which in effect is the choice of a particular social welfare function where many are possible, will drive the decision as to what constitutes the efficient allocation (Samuels, 1978, pp. 102-104).

Further, due to the non-uniqueness of efficiency, efficiency is inevitably bound up with distribution; as Samuels and Schmid (1981, p. 2) describe it, 'the concept of efficiency as separate from distribution is false'. Rights determination is a normative activity with both efficiency and distributional consequences, determining which efficient allocation and which distribution of benefits and costs will carry the day. Rights determine the distribution of income and wealth, which in turn determines the efficient solution that is reached. But at the same time, the specification of rights and the resulting efficient outcome, structure the future distribution of income and wealth in society. The choice of rights, then, is ultimately a distributional issue: 'With no unique optimal use of resources and opportunities independent of rights identification and assignment, the legal system must select the [distributional] result to be pursued: *the definition of the efficient solution is both the object and the subject of the legal system*' (Samuels, 1978, p. 106, emphasis in original). In institutional law and economics '[t]he distribution problem, viz., of power, income, wealth, opportunity, exposure and sacrifice, is critical to legal-economic research and policy' (Samuels, 1975, p. 70). Thus, as described by Schmid (1989, p. 69), 'the whole point is that global welfare maximization is meaningless' and '[t]o recommend one right over another, analysts must take their stand as naked normativists without the comfort of the Pareto-better cloak or any other formalism'.

The recognition of the multiplicity of efficient solutions and the contingency of any given efficient solution on the presumed structure of rights (the definition and assignment) and the definition of output reveals the inherent normative element that is present in efficiency-based decision making. Each possible legal solution points to a different efficient outcome and '[t]here is no independent test by which the law's solutions can be said to be the efficient solution' (Samuels, 1981, p. 155). The determination of a particular efficient solution involves a normative and selective choice as to whose interests will be accommodated, who will realize gains and who will realize losses.

This line of reasoning leads institutionalists to reject the efficiency theory of the common law. Any given rights structure will produce an efficient or wealth-maximizing outcome and thus '[t]he so-called efficiency of the common law is an 'empirical regularity' only in the sense that every common law specification of rights can produce a unique, wealth-maximizing outcome' (Samuels, 1981, p. 162). If different interests had been protected as rights, different efficient outcomes would have occurred. The choice of certain rights structures reflects a normative choice for a particular efficient pattern of law and economic development over time, where different decisions would have led to different patterns of efficient development. Thus, the literature purporting to explain the efficient development of the common law 'explains everything and nothing' Samuels (1981, p. 162). 'Wealth maximization cannot ... explain the evolution of the common law: any developmental logic concerning rights in a market economy would have led the common law to some wealth-maximizing result' (Samuels, 1981, p. 154).

In a similar vein, proponents of institutional law and economics also reject the standard theory of rent seeking, which defines rent-seeking activities as 'resource-wasting activities of individuals in seeking transfers of wealth through the aegis of the state' (Buchanan, Tollison and Tullock, 1980, p. ix). Rent-seeking theory thereby argues that expenditures of scarce resources by agents in an attempt to garner a privileged position (for example, an exclusive monopoly franchise) from the state, or, the use of the state (for example, through legislative activities or lobbying) to alter product price and/or factor prices to enhance profits without a concomitant increase in output, is wasteful in that resources are expended solely for the purpose of effecting a transfer of rents from one party to another. The normative thrust of this theory thus becomes one of promoting policies designed to avoid wasteful, rent-seeking activities, which often involves a greater, more exclusive reliance on markets and a scaling back of government.

The intellectual construct employed by proponents of the rent-seeking literature is that of the competitive market economy and the legitimized product and factor prices and thus profits that obtain therefrom. Prices and profits that occur consequent standard marketplace phenomena - such as the entering and exiting of firms into and from industries, adopting new technologies, altering the scale of plant, and so on - are all legitimate. However, when prices and profits are altered by and/or through the aegis of the state, this is said to result in waste.

From the standpoint of institutional law and economics, this characterization of rent seeking is an exercise in selective perception and market legitimation (Samuels and Mercurio, 1984, pp. 55-70). As the institutionalists have pointed out, to use today's market prices and profits as a basis to determine rents and wastes is to give propriety to extant laws

governing the production of goods while at the same time selectively culling out one subset of rights to make claims of wasteful, rent-seeking activity. It is the proponents' reliance on the model of competition that gives effect to this selective perception. As is made clear in institutional law and economics, models of the economy predicated on price-taking behavior are in reality models of rights-taking behavior. Market prices are not absolute, predetermined and independent of law, but, rather, are a partial function of rights - the latter related directly to the government's ubiquitous role in creating, defining, assigning, enforcing and altering rights. Moreover, today's prevailing market prices of products and factors of production are all predicated upon the past use of the state and past rent-seeking activities. Market-generated product and factor prices that make up a firm's revenue-cost calculation are property-rights specific; as a consequence, so too is its net revenue calculation a function of rights. The government's role in the economy remains ubiquitous and, accordingly, a theory that purports to identify rent-seeking behavior and the economic wastes therefrom is question begging. There are no *correct* rights, prices, profits, or correct structure of rents. Thus, rent-seeking theory is characterized as an artificial, misguided normative theory that will 'mislead positive analysis and generate artificial distinctions and thereby provide no real basis for distinguishing between permissible and impermissible activities' (Samuels and Mercurio, 1984, p. 67; see also Medema, 1991).

13. Toward a Comparative Institutional Analysis

The driving force behind institutional law and economics is the need to come to grips with the interrelations between legal and economic processes. Samuels (1975, p. 72) identifies three efforts that are central to this process: (1) 'models of legal-political and economic interaction' must be developed; (2) 'objective, positive, empirical studies of government as both a dependent and independent variable and of economic activity as both an input and an output of political-legal processes' must be undertaken; and (3) efforts must be made 'to wed both theoretical and empirical analyses toward a self-consciously objective, positive comprehension of law and economics'. Such analysis will serve the twin purposes of deepening the understanding of legal and economic processes and their interrelations and providing a more sound basis upon which to predict the potential consequences of legal-economic change.

The import of this becomes clear in the institutionalist assertion that the essential normative element in political-legal-economic decision making means that a choice must be made between alternative

efficiency-distributional results and hence between alternative political-legal-economic institutional structures. This, in turn, necessitates a comparative institutional approach to legal-economic analysis. The institutional structure cannot, in this view, merely be assumed away or taken as given. Rather, it must be the subject of study and, more specifically, the legal-economic decision-making process must involve a comparison of the effects of institutional alternatives on social well-being. The need for a comparative institutional approach to legal-economic policy and not only by the institutionalists, has long been recognized. Other proponents of a comparative institutional approach, coming from somewhat different perspectives include Coase (1960, esp. pp. 42-44), Demsetz (1969), Komesar (1981, 1994), Stewart (1987) and Shepsle and Weingast (1984) generally, though not exclusively, working under the banner of the New Institutional Law and Economics.

The comparative institutional approach is general rather than partial (Samuels 1972a, pp. 582, 585) and consists of describing and analyzing the systematic relationship between (1) the structure of political-legal-economic institutions, focusing on the rights and rules by which they operate; (2) the conduct or observed behavior in light of the incentives (penalties and rewards) created by the structure of institutions; (3) the consequent economic performance, i.e., the allocation *and* distribution of resources that determine the character of economic life under these institutions (Mercurio, 1989b, p. 11, emphasis in original).

Within this structure-conduct-performance paradigm the object, then, is to explain and compare the outcomes that will occur under real, discrete, alternative institutional structures. A comparative institutional approach to law and economics emphasizes the need to explain and analyze the available alternatives and the consequences of choice at three distinct stages: (1) the constitutional stage of choice - the social contract that binds people together, which is subject to reinterpretation and revision; (2) the institutional stage of choice - the structuring and restructuring of political-legal-economic institutions; and (3) the economic impact stage of choice - describing the economic impacts of existing or potentially revised legal-economic relations, be they in the form of private property rights, status rights, communal property (Mercurio, 1989b, pp. 3-6) and open-access resources (Mercurio, 1997).

The analysis must be done at each of these levels and not solely in terms of efficiency, but also in terms of the distribution of income and wealth, employment rates and any other factors that may affect the quality of life or the productive capacity of firms. As Samuels (1981, p. 165) has argued, '[f]or law to be preoccupied solely with economic maximization would rob law of life and of much of what makes for human meaning and significance'. The goal here is not normative judgment, but description: 'A

viable approach to the study of the interrelations between law and economics should be content with describing the full array of economic impacts (including both the allocation and distribution of resources) of alternative institutions and legal arrangements together with an articulation of whose interests will be served and at whose expense' (Mercurio, 1989b, p. 12). Such analysis will not privilege one set of interests over others, but it will enable those who study and participate in the processes of the legal-economic nexus to better understand these processes and their resulting effects on law and economy (Samuels, 1989a, p. 1578). Institutional-oriented case studies include the works of Carter (1985), Schmid (1985), Seidman (1973) and Wandschneider (1986). Carter (1985) criticizes the neoclassical microeconomic explanation of institutional arrangements as at best partial and at worst mystifying. Employing a Wisconsin institutionalist perspective that recognizes both the relevance of economic power and the historical context within which exchange occurs, Carter revisits Commons's analysis of 'yellow dog' labor contracts and analyzes the interlinked tenure-credit contracts. Seidman (1973) contrasts the classical and anticlassical perspectives on facilitative law and finds the latter, which recognizes the asymmetric status and power of parties to a contract to be controlling, to better describe what transpired in the colonial African economies of Kenya and Ghana. Schmid (1985), writing on biotechnology-related property rights issues in the agricultural sector, demonstrates that attempts to provide exclusivity may inadvertently create added costs and affect the choice of breeding method and agricultural technologies, as well as the division of rents between inventors and the public. Wandschneider (1986) analyzes the property rights institutions that allocate water in the northwest US. He finds that, as compared to the EPR (efficient property rights) model, an institutionalist model that recognizes (1) that social norms may supersede economic rationality and (2) that conflict over distributional issues may block Pareto-better outcomes, is better able to explain the development of rights to water in the US.

Of course normative judgments must be made in the process of reaching legal decisions. Recognizing this, the institutional approach emphasizes the need for openness and value clarification in the political-legal-economic decision-making process, clearly a legacy of the legal realist movement within the field of law (Samuels, 1989a, p. 1573). Economists, legal scholars, policymakers and judges should strive to make the value premises underlying their conclusions as explicit as possible, so that the choice process can be effectuated 'carefully and overtly' rather than 'carelessly and

covertly' (Samuels, 1978, p. 113; 1989b). This call for openness is clearly tied to the comparative institutional method:

Not only should normative premises be made explicit, but an array of studies should be conducted on the basis of *alternative* normative (and factual) assumptions. To do only one study is to give effect to only one perception and specification of outputs, costs, benefits and rights. Alternative studies call attention to the subtle intrusion of ideology and partisanship, emphasize the necessary and inevitable critical choice of underlying values, highlight the fundamental distributional consequences that depend on the political determination of output definitions and so forth. (Samuels 1978, p. 112, emphasis in original)

The obfuscation of values and underlying normative premises within so much of the Chicago school of law and economics and public choice theory is the bane of the comparative institutional approach. Relying solely on the Pareto efficiency criterion serves to obfuscate and impede the normative choice process that is necessarily at work in the legal-economic nexus. Examples of scholarship that avoid much of the obfuscation brought on by solely relying on Pareto-efficiency analysis include Bromley (1989), Calabresi (1985, 1991), Lang (1980), Griffin (1991, 1995) and Mishan (1972).

Calabresi (1991) demonstrates that the frequently-made distinction between removing inefficiencies (making moves *to* the Pareto frontier) and innovating (pushing the Pareto frontier *outward*) is a false dichotomy. He argues that moves from the status quo are not possible without either (1) disadvantaging at least one party (hence making distributional considerations unavoidable), or (2) trying to shift the frontier outward (a process that also typically entails distributional consequences). As a consequence, Calabresi, in a combined concern for efficiency and distribution, calls for a method of analysis that attempts to answer the following question: Which actions are most likely, at least cost, to shift the frontier outward and who will gain and who will lose from such moves?

Calabresi (1985) also argues that ideals, beliefs and attitudes matter in shaping the law. Recognizing that legal entitlements alter our perception of benefits and costs, he examines the legal response to beliefs and attitudes. The focus on ideals, beliefs and attitudes highlights the limitations inherent in the economic analysis of legal rules. Calabresi poses the hypothetical question: How does or should a society contemplate 'improvements' - be it the automobile or any such improvement that spreads benefits and costs across society? He asks: 'Is it worth the price we pay as a society?' 'Who should pay the price?' And, given law's commitment to the concept of

reasonableness, he asks: 'Who's value system determines what is reasonable?' The thrust of the book is to compel society to understand and articulate the tradeoffs being made between the values of different segments of society as we embrace new technologies or ways of life. Consequently, the call is for an honest and open approach to resolving issues involving conflicting values and beliefs.

Lang (1980) critically examines several concepts of efficiency as related to policy analysis, exposing their normative content and thereby demonstrating the limits to efficiency-based policy analysis. He observes that property rights issues arise from different sets of values which, if reflected in policy, lead to different Pareto-efficient allocations of resources. He calls for policy analysis to (1) undertake a greater use of economic analysis to determine the *incidence* of benefits and costs associated with alternative remedies, or (2) pursue an 'instrumental economics' which places a greater degree of emphasis on the design of policies and institutions which will achieve a specified social and economic end. In a similar vein, Mishan (1972) critically examines Hochman and Rodgers' (1969) position that one can resolve the distribution problem for society by promoting Pareto-efficient redistributions. After exploring the undesirability of efficiency-derived distributions, Mishan concludes that economists ought to concede that welfare economics is founded on ethics and make policy recommendations or proposals consistent with the ethics of the society for which the policy is intended.

Griffin (1991) critiques the traditional market- and price-guided policies for internalizing externalities offered within the context of neoclassical theory - policies which, he argues, are insufficient for this purpose. He contends that the major omission in neoclassical theory is a mechanism to incorporate institutional options (and their associated transaction costs) to resolve the problems brought on by negative externalities and he advances a method of explicitly incorporating institutional transaction costs into welfare diagrammatics. In a later paper, Griffin (1995) examined the differences between the economic criteria of potential Pareto improvements and Pareto improvements as normative foundations from which to assess public policy. He demonstrates that potential Pareto criteria have greater disciplinary acceptance than their normative foundations merit and that the Pareto criterion has suffered undue criticism consequent the former.

14. Summary

In contrast to some other approaches to law and economics, the institutional approach draws no distinction between jurisprudential, legislative, bureaucratic, or regulatory treatments. All are seen as particular parts or manifestations of the interrelation of government and the economy, or of legal and economic processes. Underlying the major thrust of the institutional approach to law and economics are two complementary modes of analysis. Instead of concentrating on a unidirectional sequence in which the law or legal structure governs behavior or conduct in the mixed market economy which in turn drives economic performance, for institutional law and economics the emphasis is on the interpenetration and interrelations between government and the economy, so that law or legal structure and behavior or conduct in the mixed market economy and economic performance are dependent on each other in a process of circular and cumulative causation.

Correlatively, whereas some of the more orthodox approaches to law and economics seek unique, determinate optimal equilibrium solutions, institutional law and economics finds such solutions to be question-begging and concentrates on identifying and analyzing the processes by which the various legal structures, the conduct and the economic performance are worked out. Similarly, those contributing to institutionalist law and economics do not feel obliged to identify particular legal arrangements as 'optimal'. They argue that putatively optimal solutions to problems of policy only give effect to selective preconceptions and assumptions as to whose interests are to count, for which economists have no particular basis on which to choose, especially given that so-called optimal solutions are driven by and specific to the choice of rights and so on which produce them - ironically with those very rights structures which are at center stage in virtually all schools of thought of law and economics.

Although institutionalists are interested in identifying the alternatives open to policy and trying to say something of their consequences, they are reluctant to substitute their preferences for those of actual legal and economic actors engaged in the processes of working solutions out by and for themselves. Along comparable lines, institutional law and economics distinguishes between (1a) a *market economy* (typically a mixed-market economy, often somewhat vague on 'the mix'), (1b) a *conceptual market* (a market typically characterized with a vaguely described 'minimalist government' in the context of 'pure competition') and (1c) *markets in general* (typically a euphemism invoked to avoid the important factors and details inherent in the previous two conceptions of the market) on the one hand and (2) *actual institutionalized markets* on the other. Accordingly, they question the blind reliance on 'the market' - whether type a, b, or c to solve

problems inasmuch as institutionalized markets, in their view, are a function of the institutions and power structures which form and operate through them. To affirm a solution by a 'market' together with the outcome which obtains and is purported to be optimal, is to give effect to a particular structure of law, rights and therefore power, and thus beg the operative issue(s). For those who narrowly seek markets and putatively optimal solutions to problems of policy, institutional law and economics will be disappointing.

It may well be that since the overtly positive and even agnostic approach of institutional law and economics is not comforting to those who would seek refuge in determinate solutions to the questions of legal-economic policy, then some may be inclined to dismiss it on this ground. Against this, Schmid responds: 'If [institutional law and economics] has no dispositive answer to resolve policy arguments, what is it good for? It can identify many less than obvious sources of power in an economy so that people can know where their welfare comes from. It can raise the level of normative debate so that issues can be joined and people can live with tragic choices rather than ignoring and dismissing them' (Schmid, 1994, pp. 36-37). While singular solutions to legal-economic issues reflect only one particular set of value premises and one particular conception of the facts, benefits and costs at issue, the comparative institutional approach, by recognizing the multiplicity of potential solutions and underlying value premises, attempts to flesh out both what is actually going on in the legal-economic nexus and the alternative possibilities that are open to society in the ongoing social construction and reconstruction of legal-economic reality.

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