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Functional Law and Economics

Contributors: **Author:**Jonathan Klick

Edited by: David S. Clark

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Though Ronald Coase's *The Problem of Social Cost* (1960) is generally considered to have begun the law and economics movement, the application of economic theory and methods to legal issues can be found much earlier. Indeed, Adam Smith's (1723–1790) own analysis of the effects of the licensing of professionals is an early example of what one would today consider law and economics scholarship. However, Coase's work can be thought of as the beginning of the first identifiable school of thought in law and economics scholarship—the Chicago, or positive, School of law and economics.

Approaches to Law and Economics

Proponents of the Chicago School argue that market forces cause the common law to develop efficient, or wealth maximizing, legal rules. As suggested by the Coase Theorem, only transaction costs will impede first best efficiency. Much of positive law and economics scholarship involves explaining how common law rules provide individuals with proper incentives such that society's wealth is maximized. To the extent that positive law and economics has prescriptive elements, they tend to involve reducing the transaction costs that stand in the way of this wealth maximization. While the positive arguments apply less well to statutory law, adherents of the Chicago School often argue that market forces in the political arena will also tend to generate wealth maximizing outcomes, subject to the transaction cost proviso. In the choice between having politicians or courts govern individual behavior, the positive school favors the institution facing the lowest transactions costs.

The second major school of law and economics thought to emerge was the Yale, or normative, School of law and economics. As distinct from the positive school, the normative school is much more skeptical of the natural development of common law, because of the presence of market failures that impede the achievement of efficiency. Furthermore, proponents of the normative school suggest that efficiency is only one of many normative goals that one can and should pursue through the law. Of particular importance for these individuals is the potential for legal institutions to bring about redistribution of resources. In this worldview, legal tools are to be micromanaged to achieve broader social goals.

Individuals subscribing to the functional school of law and economics are both less sanguine about the efficiency tendencies of the common law and the ability of legal and political elites to micromanage decisions to achieve nonefficiency goals. While functional law and economics scholars do recognize the potential for market failures to inhibit the common law from naturally achieving wealth maximization, they also draw from the field of public choice economics to highlight the dangers of giving political or judicial policy makers substantial discretion.

Constitutional Design and Metarules

Drawing on the field of constitutional political economy, the functional law and economics school focuses on incentive-compatible metarules to which rational individuals would consent at the constitutional stage of decision making while they are uncertain as to how those rules will directly affect their own self-interest. This constitutional perspective was first used in economics by James Buchanan and Gordon Tullock in 1962 and bears a good deal of resemblance to the “veil of ignorance” mechanism introduced by John Rawls in 1971. The *ex ante* perspective avoids the temptation to engage in microlevel social engineering because it depends on committing to rules that will be optimal in expectation, while recognizing that those rules will likely generate undesirable outcomes from time to time.

The constitutional design element of functional law and economics deviates from the Chicago School to the extent that “efficient” institutions are not assumed simply to evolve over time. Instead, functionalists take the design of incentive-compatible institutions in which individual incentives are harnessed to reach the social goals agreed upon at the constitutional stage as their primary function. Recognizing that market failures limit the natural evolution of efficient legal rules, functionalists attempt to design institutions that internalize the external costs and benefits created by individual behavior to achieve the social goals chosen at the constitutional stage. However, also recognizing the existence of government failure, functionalists are not willing to allow political and legal elites or majorities to align individual actions with social goals on an issue-

by-issue basis. Eschewing any romantic visions of government or the courts, functionalists assume that public figures are self-interested and will pursue their own interests instead of the social interests that would be acceptable to all at the constitutional stage.

To mediate the tension between distrusting the natural evolution of law and being suspicious of government or legal interference in social interactions, functionalists examine both formal and informal institutions to determine the underlying processes that give rise to the institutions and whether the institutions would be acceptable to a rational individual at the constitutional stage. The benchmark against which one should judge the value of any institution is an individual's ex ante decision to submit to the institution or the proposed change to the institution. This benchmark implies a modified unanimity rule in which adoption or modification of a social institution requires effective unanimity among those affected by the institution.

While true unanimity is the ideal, functionalists recognize that, at the constitutional stage, individuals would voluntarily agree to a subunanimity rule because of the transaction costs generated by requiring unanimous agreement. In practice, the inquiry advocated by functional law and economics scholars requires an investigation into the origins of the social institution, the incentives created by the social institution, and an articulation of the conditions that have changed making the original consent to the institution no longer tenable from the ex ante perspective.

Conclusion

Functional law and economics rejects the efficiency claims of the positive school and is skeptical of the normative school's willingness to allow judicial and political elites to micromanage social interactions. Informed by public choice theory, functionalists are hesitant to trade market failures for government failures. Instead, they focus their attention on constitutional design issues and favor metarules that give prominence to individual choice and consent ex ante.

- economics and law
- functional law and economics
- functionalism
- transaction cost theory
- market failure
- economics
- law schools

Jonathan Klick

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See also

- [Chicago School of Law and Economics](#)
- [Coase Theorem](#)
- [Constitutional Law, Economics of](#)
- [Efficiency](#)
- [Normative Economics](#)
- [Public Choice](#)
- [Smith, Adam](#)
- [Transaction Costs](#)

Further Readings

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