# What Should Empirical Legal Economists Do?

*Comment*

by

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## *1 Introduction*

Christoph Engel (2018) argues that empirical work in law is fundamentally different from empirical work in the social sciences generally. Because of this, he implores empirical legal scholars to rethink their approach. Specifically, Engel suggests that empirical social scientists are primarily interested in understanding and predicting behavior, whereas empirical lawyers wish to improve society. More specifically, he argues that empirical legal scholars desire to make legal policy proposals, whereas the nonlegal (illegal?) social scientists are content to be mere observers. Showing that he is a lawyer more than a content-to-observe social scientist, Engel suggests a number of adjustments empirical legal scholars should make.

Engel's suggestions, however, largely track what empirical social scientists actually do. Although in general it is probably good to be suspicious when a lawyer tells you he is trying to make the world a better place, this motivation is not very different from what drives empirical scholars generally. Similarly, Engel's particular prescriptions would not be out of place outside empirical legal scholarship.

## *2 Everybody Aims to Better Society*

Engel (2018, section 2) writes, "For a social scientist, the causal relationship is itself the research question. […] For a legal scholar, the causal relationship is an argument. Her research question is normative. […] At the highest level of generality, this purpose is social betterment." Page through any economics journal, and it is almost certainly the case that even the most abstruse article has some mention of the policy implications of the article's findings. I presume this is often the case in other social sciences as well, though I am not as familiar with the literatures outside my social science, economics. Even in those exceptions where policy connections are not explicitly made, the reason most of us engage in research and read articles, even when focused on understanding how behavior responds to changes in costs

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and benefits, is that we want to be in a better position to make decisions regarding policy (broadly defined), including the possibility that the best policy may be no policy at all.

Engel goes on to suggest that the institutional embeddedness of legal policy decisions is another aspect that makes the task of empirical legal scholars different from that of social scientists more generally. This too strikes me as odd. Engel indicates that because "new law is not designed from scratch" (section 3), the analyses and policy recommendations of the empirical legal scholar are both incremental and comparative. It is not clear how this is different outside the legal context. Any policy analysis or behavioral analysis that feeds into a policy analysis will be compared with what we already do and what we think we know about the costs and benefits of the existing approach. When Engel writes "any legal reform is fraught with uncertainty, while the existing regime has stood the test of time" (section 3), he could have just as easily dropped "legal" and the point would have been universally applicable.

## *3 The Toolbox Is the Same*

Engel then offers some specific suggestions as to how the empirical tools of an empirical legal scholar should be different from those of an empirical social scientist more generally. Here too, though, it is hard to see the difference.

Treatment-effect heterogeneity appears to be an issue that differentiates empirical legal work from nonlegal empirical work, according to Engel. Of course, concerns about treatment-effect heterogeneity are not absent from empirical economics. If they were, quantile regressions would be of little value, as would the discussions of instrumental-variables techniques as identifying local average treatment effects.

Discussions about the use of different type 1 errors, paying more attention to the power of a study, and the value of Bayesian methods would not be inapt if we moved them from Engel's article into a methods article in applied econometrics more generally.

## *4 What does the Empirical Legal Economist Have to Offer?*

While I do not think the empirical lawyer economist is so different from an empirical economist in general, there are some instances where he is better equipped to handle issues than his nonlegal counterpart. First, there are some applications of empirical tools that do need to be tweaked for the legal setting (though the basic tool remains the same). Second, the ability to pay greater attention to subtle institutional differences would seem to be a comparative advantage of the empirical legal economist, though this advantage applies regardless of whether he is writing for primarily a legal audience or a social science audience.

As to the first issue, I present as an example my joint work with Jonah Gelbach (a lawyer economist) and Eric Helland (a pretend lawyer economist who has been at it so long hardly anyone can tell he is faking it) on the use of event studies in instances where there are relatively few identifying shocks (Gelbach, Helland, and Klick, 2013).

The event study is well known, having become the primary tool in the financial economist's methodological toolbox. It has been adopted by lawyers both for research purposes (e.g., examining the effect of a legal change on a firm's value) and for litigation purposes (e.g., providing evidence in a securities fraud case). Despite some specialized jargon, the event study is really just a regression of an asset's returns on a market return, other covariates, and an event indicator that is generally a binary variable taking the value of 1 when the event occurs and the value of 0 otherwise. In this regression framework, the event coefficient is the so-called abnormal or excess return (in econometrics-speak, it is the residual for the observation where the event indicator takes the value of 1), and the normal test statistic is the standardized abnormal return.

When many instances of the event are used in the estimation, as in corporate finance applications when many firms adopt a particular corporate governance policy, hypothesis testing with the event coefficient's test statistic is fairly straightforward. However, in the legal setting, where there may be a single (or at best very few) observation in which the event applies, normal testing becomes problematic. Intuitively, normal testing procedures (i.e., using critical values from a normal distribution) "work" because of the application of a central limit theorem. Such a theorem only applies, though, when there is averaging over a large enough sample. If the evidence in litigation involves a single event day, the test statistic is an average over a single element. That is, there is not really any averaging at all.

In our paper, we justify (both analytically and through simulations) an alternative approach called the SQ (for sample quantiles) approach, which is a nonparametric test in which the event coefficient is compared with the distribution of the residuals for the estimation model. It turns out, the SQ approach has both proper size and good power (relative to the conventional method). Such an approach would likely not have been investigated by nonlegal empirical economists, since they generally do not examine single (or few) event situations, and the underlying problem would never have been noticed by nonempirical lawyers, much less solved. In fact, lawyers commonly use the standard approach in litigation even though our work shows it is unreliable the way it is generally used (and so any expert opinion based on the normal approach should be inadmissible under the U.S.'s Daubert standard).

My second category where empirical legal economists add value can be illustrated by work I did with Bruce Kobayashi and Larry Ribstein (who together formed an excellent empirical legal-economist team; luckily, they were almost always together) on the effect of at-will termination agreements in franchise contracts (Klick, Kobayashi, and Ribstein, 2009, 2012).

This work involved testing Paul Rubin's (1978) claim that such clauses were transaction-cost-minimizing devices that served to rein in opportunism on the part

of franchisees who would otherwise be tempted to free-ride on the franchisor's trademark in a world of incomplete contracts and imperfect monitoring. The prediction of Rubin's claim would be that if such clauses were disallowed by law, the degree of contracting would be diminished in that some franchised units would no longer be profitable if the free-riding could not be controlled by the termination clause.

Prior to our work, a number of nonlegal economists had examined this issue (see, e.g., Brickley, Dark, and Weisbach, 1991), finding that indeed limits on termination clauses were associated with a lower degree of franchising and of economic activity by franchisors more generally. However, these nonlawyer law-and-economics scholars amazingly forgot about the Coase theorem, which indicates that if a law generates inefficiency, parties will bargain around that law as long as transaction costs are not too high. It took legal empirical economists to point out that parties can use choice-of-law and choice-of-forum clauses to avoid problematic laws, unless such clauses are also prohibited. The economists said, "Huh?" – not realizing that the effect of a law may well depend on lots of other institutional details. Indeed, once we took account of this institutional subtlety, it turned out that the laws prohibiting termination clauses only made a difference if they were coupled with restrictions on choice-of-law and choice-of-forum clauses.

These illustrations provide an indication of where empirical legal economists (and, begrudgingly, I suppose empirical lawyers, regardless of their social science denomination) can add real value to scholarship, practice, and ultimate legal decision-making. Existing tools will sometimes need to be modified to fit the legal application, and the law's subtleties are often invisible to social scientists who have not been trained in the law.



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