

ECONOMIC ANALYSIS OF LAW : THE CONCEPT AND ITS APPLICATION IN THE LAW AND PUBLIC POLICY

Johnny Ibrahim

School of Law, Post Graduate Departmen, Bhayangkara University Surabaya,
INDONESIA.

john.ibra@yahoo.com

ABSTRACT

Economic Analysis of Law is a field of study which explains the law in terms of non legal factors such as economics and the application of the legal questions in the forms of theories and empirical methods of economics and its concept in the central institutions of legal system. Economic analysis can be used to predict what effects legal rules will have, to argue for legal reform in favour of more economically efficient rule, and to predict how legal rules will change in the future. Economic analysis has also been used as an explanation of existing rules, describing in economic terms why these rules were chosen or have developed rather than alternative rules.

Keywords: Law and Economics, Efficient Rules, Public Policy

INTRODUCTION

Economic Analysis of Law, another term for **Economic Approach to the Law** or also often to be referred with the term **Law and Economics** was at the beginning the ideas of scientists of non legal school who saw the potential of utilizing the law of legal instruments in order to obtain optimal results in applying the public policy especially in the economic field. Many scientists in the field of law give positive responses to the problem of how to deal with social problems in the areas of law such as by using an economic approach which is based on the belief that human beings' problems deal with how to choose the best from various options that are related to limited resources. The answer to this question is actually one of the main issues that is learned in Economics.

Therefore, economists' contributions to apply the concept of economics to view law are very great. For example, Ronald H. Coase whose work *The Problem of Social Cost* lead him to earn the Nobel prize in Economics in 1991. Giving a review on this book, George J. Stigler Nobel laureate in Economics in 1982, called it as the Coase Theorem, due to the fact that Coase himself never actually thought of coining a theorem. Another important work is *Crime and Punishment: An Economic Approach* by Gary S. Becker. Related to Coase's and Stigler's thoughts, the emergence of a work of a judge, namely Guido Calabresi on the U.S. Court of Appeals for the Second Circuit entitled *The Cost of Accidents: A Legal and Economic Analysis*, published in 1970. Previously appeared monumental work of Richard H. Posner, entitled *Economic Analysis of Law*.

In general, economic analysis of law operates by using the method of economics as a theoretical framework to analyze the rules and laws that are used in a particular society. The use of economics methods allow the originator of economic analysis of law to draw conclusions about human desires and the consequences in terms of the law and how the best of legal setting should be made. Range of predictions of human behavior on law imposition that is conducted through an analysis of the various models of the curve is usually done in

Economic sciences with the help of the precision of mathematics. Therefore, the scientific claim based on the applications of economics and jurisprudence is easier to be justified.

Actually, the debate about whether the law should have the awareness making law consideration based on economic concepts, such as economic efficiency in a legal judgment, has long been debated among legal scholars. Many opinions stating that the considerations of economic efficiency have become the background of various legal decisions in the common law system with reference to some important cases (landmark decisions). The rise of American Realism School in the United States which is based on observation of what the judge decided in court, among others, explains that many non-legal factors such as Economics (Coubrey & White 1996: 240) influences judgment the judges in deciding cases.

Based on the ideas, there appears a new approach that is made to the law by focusing on only one non-legal factor that is through economic approach. The choice, in terms of the practical course is based on the limitations of human factors that conduct the analysis with a variety of different scientific disciplines. Aware the debate that will arise over the use of economic approaches, Posner (1975: 757), one of the main proponents of the school defends the economic approach to choice of law in the following words;

It is true that anthropologists, sociologists, psychologist, political scientists and other social scientist besides economist also do positive analysis of the legal system but their work is thus far in sufficiently rich in theoretical and empirical content to afford serious competition to the economist....these fields have produced neither systematic, empirical research on legal system, nor plausible, coherent and empirically veriviable.

Posner's opinion above seems to be a culmination of what is expressed and planned by legal scholars before him such as Brandeis (1916: 461, 470) who says that: "*A lawyer who has not studied economics.... is very apt to become a public enemy.*" According to Brandeis, a lawyer who does not study economics will easily be a public enemy. Also it is said by Holmes that: "But the man of the future is the man of statistics and the master of economics". It is not surprising that in this emerging discourse, big names such as Ronald Coase, Gary S. Becker, Guido Calabresi, Richard A. Posner, and Mitchell Polinsky perform with great arguments by using the economic approach to find a solution to various legal issues that is faced by modern society.

More specific observations that are made by Cooter and Ulen even confirm that the interactions between lawyers and economists have created Competition Law (Anti Monopoly Law) and the setting of the country's economic policies. Further they argue that the economic analysis of law is an interdisciplinary subject that does not only appeal to the experts of law and economics, but also for the interest of public policy.

Researchers on public policy also realize the role of economics as a basis for the study of public policy as well as its association with the law. Among them, Jay Sigler (1977: 3-4) writes as follows:

"In recent years, political science, sociology, psychology, anthropology, philosophy and law have been drawn into the public policy approach. Probably because of the excellence of its analytical tools, economics seem to remain central"..... "The emergence of policy analysis inevitably leads to a revival of interest in law. Lawyers are needed to translate policy aims into statutes and regulations which express public policy".

The variations of public policy that have broad implications for the regulation of society for example in the field of economics are always made by using legal instruments. Therefore, the various theories used in the economic analysis should also be known by legal scholars.

Whereas, on the other hand economic scholars and enthusiasts of public policy must understand the purpose of the law to create fairness, predictability, and order for the benefit of every member of society.

METHODOLOGY

The design of this research is based on the combination of different traditions of the related sciences. Legal method that is based on the fact that law as a normative discipline and inherently has a character of *sui generis* discipline. In this stage it will be useful to use some more generalized aspects of intellectual arguments, so that legal method can be seen within the context of broader field of intellectual endeavour, rather than merely in a frame of normative discipline. Economics is a broad ranging and empirical discipline. Both in the term of the formulated questions and the methods that is used to answer. While public policy is a result of analysis between the use of legal framework and its normative explanation and economic approach to increase the wealth of society through efficient outcome. Law is the output of political system. Constitutions, statutes, administrative orders, and executive orders are indicator of policy. Law sets the framework for public policy.

Economic Concepts

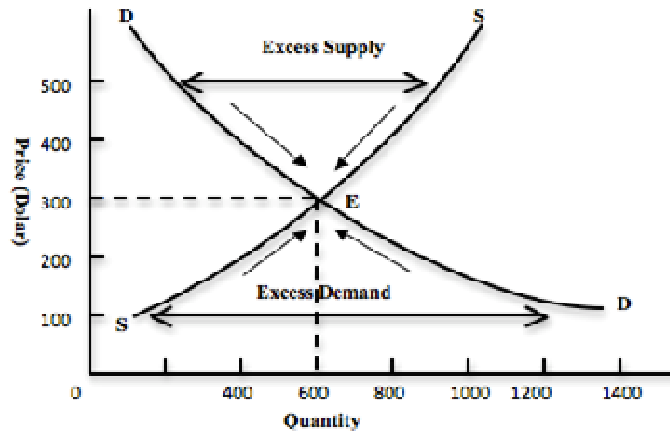
To understand the operation of the economic analysis or economic approach to law, it would require an understanding of some economic concepts that become the foundation for adopting the approach or economic analysis of law. As it has been discussed earlier, economic analysis or economic approach to law is a field of study that studies the application of the methods of economics to address legal problems that arise in day-to-day life of the community. The scope of the study includes the use of economic concepts to examine and explain the effects and consequences of the application of certain rules of law, whether the application of the law is economically efficient, and to predict what kind of law needs to be enacted that results the most great benefit for the community without sacrificing the real function of the law.

Economic Rationality

By being addressed as *homo-economicus*, the rational man is considered to have had a tendency-oriented thing that is economical. Related to this concept, economic analysis of law is built on the some general concepts in economics, such as:

- a. The maximum utilization
- b. Rationality
- c. The stability of choice and opportunity cost
- d. Distribution

On the basis of these economic concepts, economic analysis of law creates a new assumption: "the rational man will try to achieve the maximum satisfaction for him". The reason behind the idea is that in every aspect of life, people have to make certain decisions, because human nature has a desire without limit while the various existing resource availability is limited to human needs. If on one option someone may get his wish more than other options, then it will drop the best and efficient option for him and it is consistent with his choice. Dealing with the problem of making choice to create efficiency in the use of a variety of resources to achieve maximum satisfaction, is basically a focus of Microeconomic analysis. Because of that reason, the discussions of issues concerning the concept of maximization, equilibrium and efficiency is also an object of study of Microeconomics. For example, the equilibrium curve is described modestly in the following figure:



Equilibrium at point E is an intersection of the demand curve D and supply S. A higher price of USD 300, - will result in excess supply will force prices down, while a lower price under USD 300, - will lead to excess demand forcing prices up. The new price will reach a balance in the number of items offered as many as 600 units at a price of USD 300. It can be concluded that the requirement to achieve a state of balance is the amount of goods is equal to quantity of the goods that are demanded. The simplification in the form of curves like this will be greatly assisted with the help of mathematical formulas to predict *ex ante* the policies on the fields of economics that have a major impact for the wider community. The policies are generally made in the form of the rules and regulation.

Dealing with the rational human effort to achieve maximum satisfaction for him, the utilitarianism's flaw is its inability to catch the core desire of a man. While on the other hand, the economic analysis of legal finds the answer which is based on someone's desire to something is determined by how deep his willingness to pay what he wants it so that the desires can be fulfilled. The measurement can be formulated in the form of having money, or the use of other resources such as its willingness to work. In short, economic analysis of law concludes that everything can be reduced in a short phrase: how much a thing is paid for getting something or not getting a single thing.

The concept of choice and rationality leads someone to pay opportunity cost that is the cost that must be paid because of abandoning a certain choice to pursue a better one. If utilitarianism focuses on the elements of greatest happiness, then the economic analysis of the law sees it in terms of efficiency on the choice of law. Approach to efficiency on law is an effort to minimize the social cost on specific activity. For example, it is portrayed that the purpose of the law in relation to a carelessness is that an accident in an effort to minimize costs and the cost of preventing accidents. In relation to carelessness, for example, the purpose of law is to prevent an accident in which it is seen as an event that is uneconomic and therefore a person's liability to the enactment of the accident is held to prevent careless trend in road traffic conducts (Polinsky, 1989: 42).

The use of economic rationality in modern law seems to follow Max Weber who expresses the idea that modern society is a rational society where the efficiency and productivity factors have high values (Friedman 1975: 20). The use and utilization of economic rationality theory in predicting the enforcement of a legal rule are significant because the theories have been empirically proven very useful in developing hypotheses to test market behavior and have become important portions in the object of study of Microeconomics. Thomas S. Ulen outlines five reasons causing economic rationality to become the base for what is stated as the Rational Choice Theory in economics that can be applied to predict human behavior to the

enforcement of a rule of law. *First*, because the economics of human behavior can be predicted in advance and has been tested in which empirical evidences have provided supports for the effectiveness of the application of this theory.

Secondly, in the event of irregularities or deviations from the application of the theory of economic rationality, it has to be predicted in advance, based on analysis of statistical data that is publicly available and visible, so there is no reason to blame the deviation of the predictive power is meant to make the theory of economic rationality is not rational anymore. *Thirdly*, if there is an anomaly in the application of the theory of economic rationality, for example, if the prices of goods rise *ceteris paribus* demand has increased, does not make economic rationality fail to predict things that have to happen. This kind of occurrences is merely a phenomenon called "snob effect" in which they are the events reflecting the momentary desire to defend someone's will to have an item, and not a sign of his desire to make changes permanently at a cheaper price as an alternative. In terms of consumer reaction, "snob effect", is only an upward slope in the curve of demand for goods and services.

Fourthly, the rational consumers always live well to do due to rational choices they make, while on the other hand the irrational consumers lose their property so that they will be the victims of the rational consumers. The entrepreneurs running their business in a rational way in order to maximize business profits will beat those who do not do business under the rational considerations. *Fifthly*, the irrational behavior of a few people, it will still be there, but in the calculation of aggregate market behavior, their existence can be ignored (Ullen 1999: 783-794).

At the beginning, the implementation of public policies in the field of economics is used to predict exactly who should bear the burden of alternative tax. In contrast to the other bearers of social sciences, economics scientists can understand better relating how the law affects the distribution of income, welfare levels and factions or certain groups in society. Although economic scientists often refer to convey recommendations on improving efficiency, but they try to be in a neutral position to debate the issues concerning income distribution, and let the issues be decided by the government among policy makers, or decided by representatives in the parliament (Cooter and Ullen, 2000: 4).

Western economies are based on the principles of free market which aim to maximize the acquisition of wealth through economic efficiency. This principle is reflected by the common law that supports the principles of the free market as desired by the community. Common Law System provides lot of means to maximize the acquisition of wealth among others the recognition on the rights of ownership. This is certainly going through a process of exchange. Common Law also gives the protection of property rights through the Criminal Law and Civil Law. On the other hand, contract law is made to protect the process of exchanges that satisfies stakeholders. All of this is in favor of the capitalist economic system which is influenced by *laissez-faire* philosophy. Therefore, the double role that is expected to be gained from analysts of economics on law are : *the first* to reduce law in economic formula and *the second* is provide critics for judges who fail to maximize stakeholder's wealth intact (Coubrey and White, 251).

Economic Efficiency

At first the concept of efficiency is used as a criterion in the assessment of how well the market can allocate resources. In this case the economic efficiency is comparable to the effectiveness of resource allocation so that the overall economic output in the form of goods and services fully describes consumer choice of goods and services, as well as their

production of goods and services at minimum cost by using a combination of the appropriate of input factor (Pass & Lowes, 1988: 176, 189). Posner defines efficiency as: "*to denote the allocation of resources in which value is maximized*", but in the context of economic analysis, he adds that efficiency in this case is limited to the ethical criteria for the preparation of social decision making are arrangements concerning public welfare (Posner, 1992: 13).

Related to the above discussion, in Economics, positive economics is the study of 'what' is in economics rather than 'what should be'. Positive economics tries to identify the relationship between economic variables, to quantify these relationships and make predictions of what will happen if a variable is changed. With regard to the economic concept called "positive analysis", an analyst will ask the time a legal policy will be conducted in relation to predictions that can be made that have the economic effect from this point of view; people will react to incentives or disincentives as the result of the implementations of the law.

On the contrary, the normative economics is the study of what "should" in Economic Sciences which is not about "what is real", for example of the statement is that "people who earn large incomes should pay higher taxes than people who earn lower" is a normative statement. A normative statement reflects the ethical considerations such as "justice" than just economic reasons only. Economic consequences of a real tax structure that impose heavier taxes on the rich than the poor (e.g. on spending and saving) is an issue that is discussed in positive economics. Economic concept of "normative analysis" conventionally means "welfare economics", has a tendency to question whether the proposed legislation or changes in law that are implemented will affect the ways people achieve what they want. It is important to consider the two concepts in economics on efficiency. First: "*Pareto Efficiency*" or also commonly called "Pareto Optimality" that will question whether a policy or legal changes makes a person better by not causing everyone else to get worse condition.

The second is the so-called "*Kaldor-Hicks Efficiency*" which is essentially a question whether a policy or the changes will generate enough profit to those who experience the change, or in other words whether these changes provide a balanced compensation to those who are harmed by wisdom or the law changes. This approach is also known as an approach on the basis of "cost-benefit analysis" (Brix 2004: 111). Law that aims to promote economic efficiency within the framework of the free market is made in the form of government intervention in various forms of public policy.

Broadly speaking, according to Samuelson and Nordhause (1992: 50), the government has three main functions, i.e. (1) to improve the efficiency, (2) to create equity and justice, and (3) to spur economic growth and maintain macroeconomic stability. So if the problem of how to determine the choice of the efficient use of resources to achieve maximum satisfaction is the focus of Microeconomic analysis, the public policy in the context of economic efficiency, stability and growth is the focus of Macroeconomic analyst. Related to the issues, the problems on how to cope with unemployment and maximize the utilization of human and natural resources through monetary and fiscal policy belongs to Macroeconomics field of study.

Macroeconomic analysis in the preparation of legislation is to keep the implementation process through an efficient market economy. Economic analysis sees the market as the central paradigm where the exchange takes place (Tribe 1979: 66). Here the problems of selection, both the producers and consumers interact with one another, so that the choice of the most rational and efficient which ultimately gives maximum satisfaction to all market participants. Therefore, the process of exchange in a market is the primary limited resource-allocating mechanism.

Legal Rule as a Product of Legislation

In the Civil Law System, the law is a product of legislation which is the work of the House of Representatives with the President, and then the rule is a product of the executive in the regulatory framework. While the Common Law System, as the judicial process is based more on the cases that have become the law of precedent which is based on the principles of *similia similibus*. In the Common Law System, few statutory rules born of a legislative process. Economic analysis does not always draw the border between law as a product of legislation and regulation as a product of executive in order to carry out the delegated regulation.

Legal rule has several functions, including the set of human behavior, The statement can be found in careless action that causes tort, environmental, and criminal law. Law founds the equal stand point for all parties. Such arrangements can also be found in contract, business and corporate law. Law also establishes an equilibrium regarding to the rights of the individual as shown in the tax laws, and regulation of social welfare provisions (Kaplow, 1999:502).

The economic analysts think that the level of accuracy or precision of a rule is seen in the degree of detail or location-related differences. For example, environmental laws would be more precise if the various types of waste or various types of pollution sources are classified and described in clear and detail studies. Analysts on economics assess that the higher the level of precision of a rule of law, the greater cost that is made to the rules of law, also affects how a society should conform to the standards of behavior that are prescribed by the legislation. The structures and facilities that meet the standards that have been set for the business person or individual concerned do require an additional fee. The focus of attention is the choice of law analysis and application of the law or that presents options that provide the most optimal and efficient results that can be expected. The obstacles that will be faced in compiling legislative rules will be described below:

Precision Rules

More precision of a rule will involve a more complex discussion that is set in detail, and the set of norms will clearly limit its reach. This complexity will become the major source of complexity that is often blamed. According to Louis Kaplow, there are several sources of complexity of a rule or law but less attention. A draft of the rule and the law or legal opinion that is poorly drafted laws will be very confusing and has led to the high costs that are not outweighed by the benefits obtained information from him.

To formulate a clear definition of a legal rule requires a high technical expertise. On the other hand, the meaning of a legal rule must contain a certain limit in order to minimize the space for the interpretation of the rule of law itself. In legal literature mentioned that the precise definition of an element of lexical and stipulated element (Franken, 1983: 13). Lexical items are derived from a concept that have been known and used in common language, but the stipulated elements give particular meaning in a very specific area of law. Stipulated definition is needed in terms of the introduction of the terminology of new law, or gives new meaning to an existing term (Copi and Cohen, 1993: 132).

More precise legal arrangements to behavioral norms will result in better behavior. If those who dispose of hazardous waste are threatened by a more specific rule with more specific sanctions and not the general rule that simply equate the perpetrators of environmental pollution will obtain a double benefit. The more dangerous activities will earn more severe sanctions than others. This will generate compliance and efficiently prevent others from more careful so as not to repeat again or not to do environmental pollution. Otherwise a small

mistake also obtains legal threat lighter, thus excessive fear which has an impact is not efficient.

The Relation of Precise Rule And The Precision of A Legal Verdict

Precise legal rules have a close relationship with the precision of the resulting verdict. The effect of a precise rule of law in the process of litigation and court proceedings will be seen starting at the time when violation is found or identified, the use of expert witnesses, applied rules or provisions, burden of proof, appeal process to cassation. In the litigation process, the offenders or offenses will make the maximum effort possible to protect their own interests, despite the considerable costs spent. On the other hand, public interest will be maintained and protected, if the social benefit received is greater than the costs spent by the individual to maintain his interests in the litigation process. Seen from economic analysis point of view, an effective rule is the precise rule responded by every related individual because it provides economic incentives for compliance to these legal rules. The rule of law that is responded *ex ante*, in this case, would give a beneficial economic impact for the community.

Regulation

As it has been discussed previously, in the area of administrative law, regulations are rules designed to carry out the law (delegated regulation), whereas the implementation of the regulation is in the form of the executive decisions pertaining directly to implement the rules by the officials that are under the hierarchy of the decision-makers. In the modern constitutional system, all drafted government policies should be based on the constitution and should not be in conflict with existing legislation. The regulating of the public interest and the protection of the law on the interests of society members to create law and order, in general, is made in the form of the rule of law. In this case, regulation has two meanings. *Firstly*, regulation in its broadest sense is the arrangement of public interest that has broad impact on society and the regulation is made in the form of legislation. *Secondly*, in its narrow sense, regulation is a rule made by the executive to carry out the higher legal rule.

Johan den Hertog (1999: 223) from Utrecht University explains the meaning and the scope of understanding on regulation as follows:

“Regulation will be taken to mean the employment of legal instrument for the implementation of social-economic policy objectives. A characteristic of legal instruments is that individuals or organization can be compelled by government to comply with prescribed behavior under penalty or sanctions. Corporation can be forced, for example, to observe certain prices, to supply certain goods, to stay out of certain markets, to apply particular technique in the production process or to pay legal minimum wage. Sanctions can include fines, publicizing of violation, imprisonment, an order to make specific arrangement, an injunction against withholding certain action, or closing down the business”.

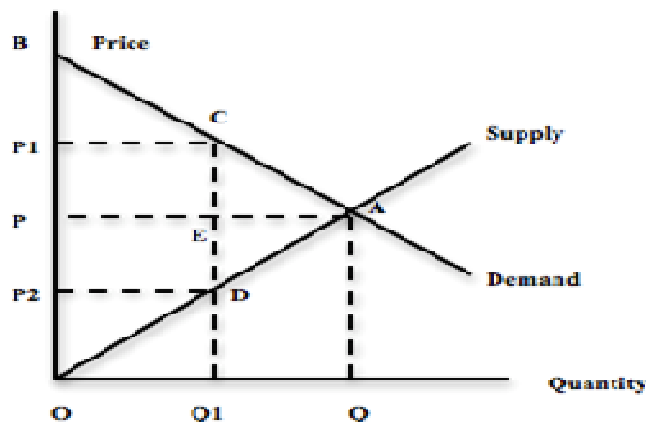
One of the points of tangency between Economics and the Law is due to the fact that various carried out state policies, including in the field of economic policy, must be implemented in the society through the legal instrument. What is proposed by den Hartog stretcher above reaffirms the legal nature that requires enforcement of a rule of law, with the threat of sanctions for those who violate it. The implementation of the threat in the form of legal sanction is applied in the form of criminal penalty (imprisonment), administrative law (fines) and even revocation of business licenses that has an impact on those who violate the closure of the business.

In the perspective of regulatory policy, economic analysis directed its attention to the costs incurred in preparing a rule of law. The intended cost details are as follows:

- the cost to develop and implement regulations;
- the cost to maintain the regulations;
- the cost to comply with the requirements specified for related industries;
- dead weight costs as the implementation of point (a) up to (c) above.*

The benefits of the implementation of regulation seen from the improvement and the increase of the level of efficiency either static or dynamic efficiency in relation to the allocation of various scarce economic resources. Static efficiency consists of productive efficiency and allocative efficiency. Productive efficiency is the efficiency obtained due to the production that is done based on the minimum cost, while allocative efficiency is obtained because a series of the right goods is manufactured. Dynamic efficiency refers to future development in managing the scarce economic resources. Through the development of organizational and technological innovation, the raw material used to produce an item will be less. The types of new products that will be produced will be referring to what is most needed by consumers. Dynamic efficiency accelerates a product to reach on the market thus economic performance will be more stable.

In regulatory policy, by considering economic efficiency considerations what is so-called deadweight loss will be prevented, that is reduction of consumer surplus and producer surplus that occurs when the output of a product is limited so that it will be lower than optimum efficiency level as illustrated in the graph below:



In a perfect competition, on the supply curve of a product with OP market price, the current price level of consumer surplus is shown in the field of APO . If the output is limited from OQ to OQ_1 , then the price paid by consumers becomes OP_1 and consumer surplus will decrease by the field of ACE , while the price received by producer fall to OP_2 and producer surplus will fall in the amount of field ADE . The conditions that allow for the deadweight loss to happen can be found in a market that is monopolistic in nature that is deliberate attempted by the perpetrators by restricting output so that the selling price of a product remains high. Such behavior is prohibited under anti-monopoly law which has been implemented in more than 80 countries around the world. Furthermore respectively, two theories of regulation will be discussed. Those two theories cover *Public Interest Theory*, the *Economic Theory of Regulation* which is also known as the *Chicago Theory of Regulation*, the discussion on the theories and the implementation is on the setting economic analysis.

Public Interest Theory

What underlying regulation for the sake of public interest deals with arrangement to provide the best possibility for the allocation of scarce resources either for the benefit of individuals or the public interest (collective) on a particular type of goods. Regulation carried out by the government in order to protect the public interest in this case regulation is an instrument to cope with the disadvantage condition of imperfect competition, unbalanced market operation, missing market, and undesirable market result.

One side to consider in designing the implementation of the Public Interest Theory of Regulation other than to maintain the balance due to market failures so that people are not harmed and economic systems remain running in the corridor which is consistent with the public interest, is because one of the causes of market failure in addition to strength monopoly, that is what is called an externality. The term externality is an economic term that refers to the side effects, either good or bad, that is caused by consuming or producing activities, such as environmental pollution that is caused by the disposal of toxic waste from factories. Nevertheless, there are also activities that bring positive results from externality such as social benefits provided by the company in training workforce to be more ready to use in their work.

Regulation that is done in the field of securities market in a modern legal system is intended to provide protection to investors, improving the efficiency of the market, complete the market with related corporate organizations (firm), provide benefits to the industrialist and to create competition in the service industry. In this case, the regulation of securities markets relies on two things. First, the arrangement is to achieve optimal efficiency, and second, setting up protection and legal settlement against fraud and abuse of trust relating to transactions in securities. As it is known, the actors in the securities markets run their business by selling or buying (buy and sell securities) under the rules that have been agreed in the so-called specialized contract (Kitch, 1999: 813).

Problems of information that is not balanced or asymmetric information can occur because one party does not have the information as accurate as others do. For example, an investor knows well the risks faced in running a business that requires the support of funds from bank loans, while those who put the funds saved in the banking industry, do not know any risks faced by the banking industry. Speculation by taking advantage of the ignorance of the parties (savers and borrowers) to their advantage is one example of moral hazard that may occur in any banking industry. In order to overcome the problem of moral hazard that can harm the depositors and money savers, it is necessary to have such arrangements through the application of the principle of openness, where financial information and accounting system of banking are always opened at any time and accurately compiled based on accounting standards under the close supervision of the monetary authority (Heremans, 1999: 228 – 229).

The Economic Theory of Regulation

The Theory of Economic Regulation firstly emerged from the writing of Richard A. Posner in 1974, entitled *The Economic Theory of Regulation*, and published in 5 *Bell Journal of Economics and Management Science*. George J. Stigler, an economist from University of Chicago, also wrote a topic on *The Theory of Economic Regulation* in the same journal in 1971 so that this theory is also called *The Chicago Theory of Regulation*. The stated theory is constructed with a proposition that is centered on the notion that as a rule, regulation is actually needed by the industry and a regulation is designed and implemented to benefit the development of the industry itself.

Through the regulatory policies carried out by the government, then there are companies that are benefited, but there are also companies that are disadvantaged. Therefore, for the sake of the interest of certain areas, a group of businesspersons approach and build an opinion so that influential politicians having the authority to determine intended regulation arrange the rules that benefit them. These approaches cannot be done individually because it requires huge funds, spending time and energy, while the results are uncertain. For large business groups, high-cost economy spent in order to negotiate with the politicians, in the long run will not affect the performance of their companies, because the costs is included in the cost of production. On the contrary, the politicians surely still want be in parliament, and to convince their constituents in order to achieve political goals, they need financial support.

Deregulation

Deregulation is the release of economic activity controlling that was previously performed by the government or through the agency / agencies established by the government. Deregulation is done because supervision is no longer needed in the end of a price control policy to prevent inflation or in a condition where government policy limits exchange rate policy (foreign exchange control). Deregulation is also a government initiative to encourage the emergence of competition, such as permitting the coming of private companies to compete in the business that has been restricted by the government.

To a condition where regulations aimed at economic equality have reached a result, it appears the signs of slowing economic activity. Therefore, the deregulation policy is needed to revitalize sectors undergoing slow activities. Areas requiring deregulation efforts generally are the economic sectors including transportation by air, land and sea, telecommunications, energy and financial sectors. Market failure can be overcome through the application of technology and the changing levels of demand. Deregulation becomes an option rather than regulation, if there is a more efficient way to find a way out due to the failure of the functioning of the market mechanism (market failure). In this framework it also appears that deregulation can bring confidence to business owners to get involved in the era of competition based on the functioning of the market mechanism.

From the previous discussion, the economic analysis of the law argues that the birth of a whole process of legislation, regulation or deregulation can be understood more deeply on the basis of the assumption that the legislators and politicians are also people who are in their position trying rationally to maximize their satisfaction as other general individuals in the community. With this assumption there is a conclusion that all they do is not merely based on the public interest, because behind the process of drafting legislation there is a compromise between interest groups (interest groups) using rational choices of the most economical in their opinion.

As described previously, in the free-market paradigm that dominates the economic regulation of industrialized countries, the market is considered to have its own mechanism to resolve the problem. However, this view gains opposition from the scholars who oppose these views. For those who oppose state that without government intervention the market cannot function properly and therefore safeguards are necessary to ensure the efficient operation of the market mechanism. Robin Malloy (1990: 7), for example, seeing from the point of view of legal justice warns:

“The market does not care about the issue of fairness or justice. Allocation of scarce resources is made on votes of dollars in the market place. The market leaves it to society to provide an equal opportunity for all people to have a chance at success and earning

the money to cast their 'vote'. As long as there is no artificial barrier to success, no one should be offended by the functioning of the market.

Thus, according to Robin Malloy, the market does not care about the real issues related to the fairness and justice that actually, the allocation of the scarce resources are made based on the choice of the exchange rate in the market. Market leaves the public to provide equal opportunities for all people to achieve success and earn money based on their choices. As long as there is no barrier to obtain success, according by Malloy, then no one will be disappointed by the functioning of the market.

Market mechanism does not always run smoothly and efficiently. Distortion of the perfect workings of the market mechanism can happen because of the practice of monopoly, oligopoly, and various forms of trade practices that hinder competition whereas the competition is a means to achieve optimal economic efficiency. Then the function of law is to provide a stepping-stone and the same rules of the game (level playing field) to the intended market participants. Competition Law or Anti-Monopoly Law is an example of a reflection on the public policy issued by the government to ensure the implementation of an efficient market.

Criticism to Economic Analysis of Law

Economic analysis of law has led to a wave of new discourse that enriches the theory and approach in the field of legal studies. The argument used by supporters turns out to have a place everywhere because of being supported by the theories and methods of economics that are easy to understand. The work of theoretical study can refine previous theoretical deficiencies (utilitarianism). And yet still, the economic analysis raises sharp criticisms especially the ones coming from the group Critical Legal Studies Movement with the originator as Roberto Mangabeira Unger, Duncan Kennedy, Mark Thusnet, Betty Mensch, Morton Horowitz and David Kairys. The main target of the criticism proposed by this movement is the concept of economic analysis that is built on the basis of liberal economic thought.

In their opinion, the market makes people become alienated because it is dominated by individual actors who are protected by the laws that perpetuate the domination, as it is shown by the law contract law with the principle of freedom of contract while the market itself contains elements of injustice. Therefore, the market is really just a means to preserve injustice. With a cynical style Unger (1986: 33) criticized the free competition:

“No wonder the program of promoting 'free competition' looks like a romantic adventure, invoked more often than not as a cover for some set of favored deals between government and big business”.

According to Unger, the program to promote 'free competition' looks like a romantic adventure, which is most often used as a cover for a series of favored agreement between the government and big businesses. This movement rejects all ideas that come from capitalism thinking because his political beliefs are based on a synthesis of three intellectual traditions: semiology, phenomenology, and Marxism. With this position, it is certainly sure that their thoughts are in the opposition with the economic analysis of law, although they were originally born from the same source that is American realism and equally recognizes that the law is very much influenced by non-legal factors.

Some legal scholars consider that the emergence of the World Trade Organization which is the recognition of the international society on the existence of the market, the thought of Critical Legal Studies movement has ended. The argument is strengthened by the fact of the

failure and collapse of communist ideology as part of the supporting thought (especially in the thinking of Roberto M. Unger dealing with "Superliberalisme"). That opinion also makes sense, but certainly one cannot deny to ignore the ideas and efforts of these groups to create what is called by Thomas Kuhn (1993: 52-53) as an anomaly, an initial opposition to what has been established in the Law in order to building a new paradigm, separated from the success or failure of idea of the Critical Legal Studies Movement.

Criticism also presented by Jon Hanson and Melissa Hart. From the internal perspective both of them state that arguments of specific legal rules will increase the efficiency and hence the rule can maximize social welfare, is basically based on a certain set of assumptions, such assumptions are based on transaction costs and many other unrealistic assumptions. Hanson and Hart argue that models of approach developed in Law and Economics, are based on the assumption that is very often different from reality. For example, in highlighting the cost of an accident where the cost functions is not only on the level of care alone, but also on the level of activity. Hanson and Hart (1996: 321) also saw the level of difficulty in the judicial practice of law, when the judge and the jury for practical reasons do not have sufficient information to perform precise mathematical calculations in order to make a fair decision in matters dealing with the accident:

"To deter all accidents that could be cost-justified prevented, judges and juries would need to compare the benefits of a party obtains from greater participation in the activity to the resulting increase in expected accident cost. Unfortunately, courts tend to ignore activity level of consideration, and most scholars believe that, as a practical matter, courts are unable to conduct the necessary activity level calculus, because of the amount of information they could need".

It must be admitted that the criticism in the internal perspective proposed by Jon Hanson and Melissa Hart above is in practical level, if it is faced with the real world in the practice of law enforcement, particularly the judicial level, the valid proven theories generated based on studies of Law and Economics, are almost having no benefit. For example, the case of *United States v. Microsoft Corporation*, 56F. 3d. 1448 (1995), Microsoft's defense for the sake of efficiency is considered by the judge as efficiency did not manage to act as an acceptable excuse.

Only certain judges who consider it as a basis for making a decision. An example is what became the basis for Judge Learned Hand in *United States v. In deciding the case of United States v. Carroll Towing*, 159 F.2d 129, 173 (2nd. Cir. 1947). In investigating the case, Hand made formula to be the basic reference of negligence, ie loss occurs only if $B < PL$, where B is the cost to prevent the events that causes harm does not occur, while P is the probability of occurrence of an event of damage, and L is the magnitude of loss. Because the legal system in the United States is based on case law, the Hand formula is still used by the judges in the cases of compensation to this day.

Against various criticisms that arise, either coming from external or internal groups, Richard Posner as one of the leading figures in the Law and Economics, has attempted to provide clarification of the criticisms aimed at economic analysis. Posner's language style used to answer the criticism that economics likes doing reductions (economics is reductionist) depicted in the curves, in the case according to Posner that criticism is not limited to the economic analysis, but aimed at the overall economics. Allegations that the economic approach to law has failed to explain the important rules, the doctrine of the law, legal institutions and the results of a legal system, are answered by Posner, that the critics should give arguments in the form of scientific theories that are more comprehensive, The criticism should be based on more valid analysis and theories.

Basically, what is proposed by economic analysis of law is very useful to understand the enforcement of antitrust law in the United States. In fact, the enforcement of antitrust law during the decade of the 1960s to the 1990s in the United States, is heavily influenced and colored by the work of Posner and his group from Chicago Law School (Kovaleff, 1994: 578) which later turns to be criticized because of failing to advance the climate of business competition in the United States, as well as result in the emergence of entrepreneurs hunting economic rents (rent seekers) which is against the principles of efficiency that they want to maintain as it is opposed by Virginia School of Public Choice.

Meanwhile a group of economists from the Chicago School of Economics such as Milton Friedman, George Stigler, Gary Becker, Alan Greenspan, William Simon, Warren Nutter, some of these names are Nobel prize winner in economics, has never seriously accept the role of the state to guarantee work opportunities (full employment) based on the idea of Alfred Marshall in his Principles of Economics. Instead, this group tends to hold their opinion that saving is a solution needed to sustain investment activities. The impetus for investments is highly dependent on the activity of doing savings driven by incentives from the benefits of saving. This group of economists prefers tax cut to reduce government intervention in the economy. As a substitute, they argue that high interest rates are the best shape for the return of capital (Turgeon: 1980: 4-5). This economic activity that later would spur investment to drive the economy, and to make the activities run smoothly, then the law must play its role in order to maintain the purity of the market, through the guidelines that must be obeyed by market participants.

Market economies tend to provide greater benefits to the parties who have the ability to work more efficiently, have the skills and have ideas and innovations that are more creative. In a market economy system that is experiencing growth, there will be groups of people who earn very high and there are segments of society that should earn very low incomes, which in fact is a very large segment of society. While the goal of every economic activity is to realize that economic justice requires every group and individual in society to be able to enjoy the results of economic activities in a fair and equitable way.

On the other hand, despite the more massive use of high-tech that is more efficient nowadays in exploiting natural resources to support human life on earth, but still the supply of non-renewable natural sources is dwindling due to increased demand. Economic injustice is shown by the flow of natural resources from underdeveloped countries into developed countries. For developing countries, the focus of the struggle is to increase economic growth and prosperity, the struggle to master the science, technology, skill, and information, as well as the struggle to resist economic pressures from developed countries. It is different, for example, from economic perspectives of developed countries which give emphasis on the mastery of economic potential, struggle to maintain the development and progress for the benefit of the present and future of the nation.

CONCLUSION AND RECOMMENDATIONS

The result of this research shows that interaction between Law and Economics has proven to be able to build a strong foundation for the formulation of public policy that refers to the efficiency associated with the use of limited resources. It is apparent that looking at the law in a broader horizon is important to do. Modern law requires breakthroughs to create justice, order, regularity and security as well as efforts to improve the welfare and maintain the existence of the human race on earth. The breakthroughs certainly need the theoretical support of various scientific fields of study.

Economic Analysis of Law or also often to be referred with the term Law and Economics, as it has been proven in many countries that are supported by related scientists, presents creative thoughts and enlightening ideas heading towards a better way to reach the lofty ideals towards a new world order that is more orderly and fair. It is recommended to the Law School and School of Economics or Business School to include Economic Analysis of Law as a permanent subject teaching in university, either under graduate or post graduate level as shown in almost all reputable university in developing countries.

REFERENCES

- Ackerman, B. A. (1986). Law, Economics, and the Problem of Legal Culture. *Duke Law Journal*, 35(6), 929-947.
- Amato, Guiliano, (1997). *Antitrust and the Bounds of Power*. Oxford: Hart Publishing.
- Brandeis, L. D. (1916). The Living Law. *10 University of Illinois Law Review*
- Christoper, P. & Lowes, B. (1988). *Dictionary of Economics* (Second Edition). London: HarperCollins.
- Coase, R. H. (1960). The Problem of Social Cost. *Journal of Law and Economics*, 3(Oct), 1-44.
- Copi, I. M. & Cohen, C. (1993). *Introduction to Logic*. Collier Macmillan, Canada.
- Franken, H., et.al., *Inleiding tot de Rechtswetenschap*. Arnhem: Gouda Quint.
- Friedman, Lawrence, (1975). *The Legal System*. New York: Russel Sage Foundation.
- Hanson, J. D. & Hart, M. R. (1996). "Law and Economics", dalam Dennis Patterson (ed) 1996 : *A Companion to the Philosophy of Law and Legal Theory*, Oxford: Blackwell Publishing.
- Heremans, Dirk, (1999). Regulation of Banking and Financial Market, Center for Economic Studies and of Law and Economic, Law School of the Catholic University of Leuven, on Boudewijn Bouckaert & Gerrit de Geest (ed). *Encyclopedia of Law and Economics*, Vol 1. Chetenham: Edward Elgar.
- Hertog, Johan den, (1999). *General Theory of Regulation*, on Boudewijn Bouckaert and Gerrit de Geest (ed).
- Hilaire, M.C., Coubrey dan Nigel D. White (1996). *Textbook on Jurisprudence* (Second Edition). London: Blackstone Press Ltd.
- Holmes, & Wendel, O. (1897). The Path of the Law. *Harvard Law Review* 10 457.
- Kaplow, Louis, (1999). *General Characteristics of Rules*, Harvard Law School and National Bureau of Economic Research, on Boudewijn Bouckaert & Gerrit de Geest (ed).
- Kitch, E. W. (1999). *Regulation of the Securities Market*, University of Virginia Law School, dalam Boudewijn Bouckaert & Gerrit de Geest (ed).
- Kovaleff, T. P. (1994). *Antitrust Impulse*, M.E. Sharpe Inc., New York.
- Kuhn, T. S. (1993). *The Structure of Scientific Revolution*, Second Edition, The University of Chicago Press.
- Polinsky, A. & Mitchell, (1989). *An Introduction to Law and Economics*, Second Edition, Little, Brown and Company, Boston, 1989.

- Posner, R. A. (1992). *Economic Analysis of Law* (Fourth Edition). Boston: Little Brown & Company,
- Tribe, L. H. (1979). *Policy Science: Analysis or Ideology ?*, Philosophy & Public Affairs 2, No. 1, hlm. 66 (1972), Princeton University Press.
- Turgeon, Lynn, (1980). *The Advanced Capitalist System*. White Plains, NY: M.E. Sharpe, Inc.
- Ulen, T. S. (1999). *Rational Choice Theory in Law and Economics*, College of Law, University of Illinois at Urbana-Champaign, dalam Boudewijn Bouckaert & Gerrit de Geest (ed).
- Unger, & Mangabeira, R. (1986). *The Critical Legal Studies Movement*. Cambridge, Massachusetts: Harvard University Press.