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Program Report

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Law and Economics

Christine Jolls*

The NBER's Law and Economics Program studies the effects and causes of legal rules, with a special focus on the foundational legal subjects — property law, criminal law, contract law, and tort law — and on the operation of the legal process. In regard to the operation of the legal process, the Program examines topics such as labor markets for lawyers, litigation dynamics, judicial and agency behavior, and the determinants of legislative action. In addition, the Program studies the effects and causes of legal rules across a range of legal subjects beyond property, criminal, contract, and tort law, including corporate law, employment law, health care law, social welfare law, family law, bankruptcy law, patent and copyright law, and antitrust law.

The Program meets twice per year, once at a mid-year program meeting and again at the NBER's Summer Institute. The Program's recent special activities include a project in the area of corporate governance, under the direction of Research Associate Lucian Bebchuk; selected papers from that project are scheduled to appear in a forthcoming issue of the *Review of Financial Studies*.

In this article, I first describe recent research in the foundational legal subjects and then turn to work on the operation of the legal process. I conclude with an overview of work on the effects and causes of legal rules in corporate law, employment law, health care law, social welfare law, family law, bankruptcy law, patent and copyright law, and antitrust law.

In 2007, we converted from issuing quarterly, seasonal issues to a system of numbered issues. This is the second issue of 2008 under the new numbering system: 2008 Number 2.

* Jolls directs the NBER's Law and Economics Program and is a professor at Yale Law School. In this article, the numbers in parentheses refer to NBER Working Papers. Steven Shavell, the previous director of the Law and Economics Program, provided extremely helpful feedback on this Program Report.

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Property Law, Criminal Law, Contract Law, and Tort Law

A fundamental aspect of any legal system is the structure of property rights. Recent work by Oliver Hart (1974) is the latest in an important line of papers by Hart, Sanford Grossman, and John Moore that examine the effects of a particular conception of property rights emphasizing "residual control." In this view, the owner of an asset retains those rights to the asset that are not specifically assigned by any existing contractual commitment. While previous papers in the series have examined the effects of the residual control rights conception of property rights in the face of parties' non-contractible up-front investments, the recent paper by Hart studies the effects of property rights of this form in a model with uncertainty of values and costs of a good to be traded. Hart's model suggests that ex-ante contracting over asset ownership can reduce later incentives to engage in hold-up. A system that did not provide for property rights in the Grossman-Hart-Moore sense (reserving residual rights to the state rather than to the property owner) would be inferior within this framework.

Also central to the structure of property rights is the question of when government may obtain ownership of assets from unwilling private parties. In a recent paper (1974), Steven Shavell models the desirability of allowing government takings of private land by its eminent domain power when the government's information about owners' valuations is imperfect. Shavell shows that eminent domain becomes appealing if the number of property owners is large, in order to overcome a problem of "honest" holdout. This conclusion holds regardless of whether the land that the government seeks is a parcel at a fixed location or instead is located anywhere in a region.

A legal system determines what, if any, conduct should be subject to criminal sanctions and establishes the shape of those sanctions. An extensive recent law and economics literature studies the effects of various forms of criminalization. John Donohue and Justin Wolfers (1982) examine the potential deterrent effects of the ultimate criminal sanction — the death penalty, which is reserved predominantly for homicides. While there is some variation in the use of capital punishment, both across time and across states with different legal regimes,

Donohue and Wolfers conclude that this variation is small when compared with the large swings in the homicide rate; even when the use of the death penalty increases, the absolute number of executions remains quite small. Thus, existing results linking capital punishment to reductions in the homicide rate prove to be extremely fragile, and the data that are presently available do not allow any strong inference about even the sign of the deterrent effect of capital punishment.

Current law subjects criminal sex offenders to a variety of registration and notification laws that, respectively, require convicted sex offenders to provide valid contact information to law enforcement authorities and mandate that information about sex offenders be made public. In recent work, J.J. Prescott and Jonah E. Rockoff (13803) offer new evidence on these laws' effects. Using fine-grained information on state registration and notification laws, Prescott and Rockoff present evidence that sex offenses against neighbors declined with the adoption of registration laws and that notification laws deter potential offenders with no prior record while increasing recidivism among those who have previously committed sex offenses.

As the property rights work described earlier reveals, the value of property rights is intertwined with the ability of parties to enter into contracts governing the use of their property. Contract law determines whether and how agreements among parties will be legally enforced. A major part of the function of contract law is to determine whether and how to fill gaps in parties' contracts. Are the existing gap-filling rules of contract law efficient? Work by Surajeet Chakravarty and Bentley MacLeod (13960) provides an affirmative answer with respect to a range of contract law rules—including the important rule setting “expectation damages” as the standard measure of damages for breach of contract—in a model informed by standard industry contracting practices.

Tort law imposes civil—as distinguished from criminal—liability on certain forms of behavior that society wishes

to deter. Civil liability creates obligations of one private party to another rather than liability of an individual to the state, as in criminal law. Much recent work in tort law has been in the area of products liability—the liability of firms to consumers for injuries sustained in using a firm's products. Firms' liability generally will affect the price of products, and in recent work Andrew Daughety and Jennifer Reinganum examine consumer inferences about product quality from price variation.¹ In Daughety and Reinganum's model, price is a signal of product quality. Instead of signaling quality through price, though, firms may choose to disclose quality directly. Daughety and Reinganum show that firms may inefficiently choose signaling over disclosure of product quality when marginal cost, including the cost of legal liability, is increasing in product safety.

A. Mitchell Polinsky and Shavell (12776) also examine the relationship between products liability law and firms' disclosure behavior. In the absence of liability for product harms, there is a tradeoff between forced sharing of information and firms' willingness to accumulate information in the first place. When firms face liability irrespective of their degree of fault for the harms caused by products, by contrast, mandatory disclosure does not affect the information that is disclosed and, thus, does not affect the information that is accumulated.

In many circumstances, products liability law does make firms, irrespective of their degree of fault, liable to consumers for the harms caused by products—a regime called “strict liability.” This form of liability for product harms is ordinarily justified by reference to informational and cognitive failures of consumers, but in recent work Cass Sunstein and I (11738) explore the potential effects of responding to these failures, not with strict liability, but rather with requirements to engage in “debiasing” communications designed to reduce consumer errors. We distinguish such debiasing communications from conventional informational mechanisms and suggest that legal debiasing strategies hold significant promise

for understanding and improving diverse forms of regulation of risky products.

The Operation of the Legal Process

The legal process involves many players, including lawyers, litigants, judges, agencies that administer federal and state statutes, and legislatures. In regard to lawyers, a number of recent papers have analyzed labor markets for lawyers. In one paper, Jesse Rothstein and Albert Yoon provide empirical evidence on the so-called “mismatch hypothesis”—that affirmative action in law school admissions hurts minority students who attend more selective schools than they otherwise would have and, as a result, experience lower graduation rates and less success in passing the bar.² According to Rothstein and Yoon, mismatch effects in fact are observed only for minority students with the weakest entering credentials—students who, without affirmative action, often would not have been admitted to any law school. For minority students with moderate or strong entering credentials, Rothstein and Yoon find no evidence of mismatch effects in either graduation or bar passage rates.

Christopher Avery, Richard A. Posner, Alvin E. Roth, and I (13213) examine another aspect of the labor market for lawyers—the market for federal judicial law clerks. The hiring process for law clerks has long been characterized by the type of unraveling of transaction times that has also been observed in many other entry-level labor markets. Avery, Posner, Roth, and I surveyed both federal appellate judges and clerkship applicants and found clear evidence of substantial non-adherence to official judicial timing guidelines intended to prevent the hiring of clerks before a designated time. We describe, however, ways that judges and clerks might settle at an equilibrium level of imperfect, but still meaningful, adherence to the designated start date regime.

Lawyers, along with the clients they represent, resolve many of the lawsuits in which they are involved without any recourse to the courtroom. In fact, the

overwhelming majority of lawsuits are settled by the parties prior to trial. An important set of law and economics papers has modeled the bargaining process between opposing parties over whether to agree to a pretrial settlement. In recent work, Yasutora Watanabe fits a dynamic model of such litigant bargaining to data on the time, mode, cost, and terms of settlement of a large set of legal disputes.³ The model's fit with the data suggests that asymmetric initial beliefs and the opportunity for learning over time are important features of litigation-settlement bargaining.

Turning to judicial behavior, a line of recent papers by Andrei Shleifer and coauthors has examined common law decisionmaking in a system of judge-made law. The first paper in this series, by Shleifer and Nicola Gennaioli, models the evolution of legal rules in common law courts (11265); in the most recent work, Shleifer, Anthony Nisbett, and Richard Posner turn to a specific set of decided cases to examine the evolution of a particular legal rule in action (13856). The theoretical model provides a foundation for the evolutionary adaptability of common law, while in the actual set of decided cases there was no evidence of convergence to any stable resting point.

Judges often make decisions in groups, and in recent work Edward Glaeser and Sunstein (13687) model the evolution of group members' views as a result of deliberations. One common effect of group deliberation is polarization, in which individuals' pre-deliberation views become more extreme as a result of the deliberations. Glaeser and Sunstein show that polarization may, but need not, follow from rational Bayesian updating by group members.

Glaeser and Sunstein's analysis has implications for decisionmaking not only by judges but also, as they note, by members of decisionmaking bodies within government agencies. Other recent work in law and economics has studied a variety of effects of government agency action. For instance, Rafael La Porta, Florencio Lopez-de-Silanes, and Shleifer (9882) examine the relationship between government agency enforcement

activity and stock market development across nations. Using measures of the legal powers of government agencies charged with enforcement of securities laws, they find little relationship. Howell Jackson and Mark Roe, by contrast, use measures of budgets and staffing of such securities enforcement agencies in several samples of about 40 nations and find significant association between enforcement agencies' resources and those nations' financial market outcomes.⁴

A third type of body engaged in law making and law enforcement, alongside courts and government agencies, is the legislature. Legislative behavior may be influenced by, among other things, campaign contributions and the information that legislators receive from lobbyists and other interest-group actors. Recent work by Charles Cameron and John de Figueiredo offers empirical evidence on the second, information-mediated type of influence.⁵ They find strong evidence that interest-group expenditures on informational lobbying vary with legislative budget cycles—rather than electoral cycles—as well as with the ideological distance between the interest group and the party in legislative power. Cameron and de Figueiredo's empirical results are consistent with leading theoretical models on informational lobbying.

Corporate Law, Employment Law, Health Care Law, Social Welfare Law, Family Law, Bankruptcy Law, Patent and Copyright Law, and Antitrust Law

An extremely active area of research considers the effects and causes of corporate law. Papers in this area have been featured both in regular Law and Economics Program sessions and in sessions conducted by the Corporate Governance Project.

In studying the effects of corporate law rules, much recent attention has been paid to legal rules—many of them enacted in the wake of the collapse of Enron—requiring increased trans-

parency of corporate financial information. Benjamin Hermalin and Michael Weisbach (12875) offer a model in which such increased transparency may, contrary to its presumed intent, reduce firm profits and increase executive compensation. Increased transparency in Hermalin and Weisbach's model may also increase the rate of turnover of chief executive officers.

Backdating of stock option grants has been a source of substantial Securities and Exchange Commission activity, as well as private litigation, in recent years. In a pair of studies (12771, 12811), Bebchuk, Yaniv Grinstein, and Urs Peyer document both the frequency and the corporate governance correlates of option grant backdating and other forms of opportunistic option grant timing. The correlates of such behavior include a smaller fraction of independent members of the board of directors (for both CEO option grants and director option grants) and longer CEO tenure (for CEO option grants).

Corporate law structures the exercise of shareholder votes, and recent work by Yair Listokin studies the effects of the existing structure on voting outcomes.⁶ Listokin examines the results of shareholder voting on management-sponsored resolutions in “close” cases, in which management's share of the vote is within 10 percentage points of the cutoff point for success (which is typically 50 percent). He finds that management overwhelmingly wins these close votes. His conclusion is that the existing structure of shareholder voting is not effective in producing voting outcomes that mirror underlying shareholder preferences.

Alongside the study of the effects of corporate law, recent research examines the causes of corporate law. In a model of interest group lobbying in the context of corporate lawmaking (13702), Bebchuk and Zvika Neeman identify a range of circumstances under which such lobbying leads to an inefficiently low level of investor protection. Their model indicates that observed correlations between countries' levels of investor protection and these countries' economic performance may reflect the effects of the second factor on

the first as well as (what has been emphasized by the existing literature) the effects of the first factor on the second.

In addition to managers and shareholders, firms are populated by employees, whose relationship with their firm is regulated by employment law. Many provisions of employment law mandate that particular benefits be provided to employees. One very economically significant mandate in the employment context is the Social Security program, which requires payroll deductions to fund government benefits upon disability or retirement of employees. Research by David Autor and Mark Duggan (12436) analyzes upward trends in the level of Social Security disability payments in recent decades. Autor and Duggan link these increases to changes in legal qualification standards, in real benefit levels, and in the size of the workforce.

Recent work by Louis Kaplow (12452) analyzes Social Security using a model that incorporates myopia on the part of employees. Kaplow studies the effect of Social Security on labor supply in the presence of myopic employees who give excessive weight to present payroll deductions that finance distant future benefits. Kaplow's model shows that even with myopia, Social Security may cause labor supply either to rise or to fall depending on the curvature of individuals' utility as a function of consumption and on whether individuals' myopia extends to labor supply choice as well as savings decisions.

Another important federal employment mandate involves medical leave under the Family and Medical Leave Act of 1993 (FMLA), which I study in a recent paper.⁷ Exploiting variation across states in the presence or absence of mandated medical leave at the state level prior to the FMLA's enactment, I find positive employment effects of mandated medical leave for individuals with disabilities. I suggest that this result may reflect the absence of hiring disincentives from mandated medical leave given the limited observability of many leave-necessitating medical conditions at the time of hiring.

Health care law is a rapidly grow-

ing field spanning an enormous range of research questions. One important question concerns the effects of legal rules intended to increase the availability to patients of health-care-related information. Recent work by M. Kate Bundorf, Natalie Chun, Gopi Shah Goda, and Daniel P. Kessler (13888) studies the effects of mandated health care provider "report cards" that include detailed information on medical outcomes. Using a unique identification strategy, the authors find that mandated birth-rate information for infertility treatment centers increases the market share of centers with high success rates.

Medical malpractice is another major aspect of health care law (as well as an aspect of tort law). In a recent paper, Janet Currie and MacLeod (12478) study the effects of medical malpractice law reform within the field of obstetrics—a branch of medicine thought to have been particularly hard hit by the "liability crisis" in medical malpractice law. Thus, Currie and MacLeod examine how reform in this area has affected the types of procedures performed in childbirth and the ensuing health outcomes. They introduce a model of physician behavior that allows for differential effects across patient characteristics and that provides a new way to model alternative liability rules. Empirically, Currie and MacLeod find that while some medical malpractice reforms have positive effects on health outcomes, imposing caps on non-economic damages has negative effects.

Patricia Born, W. Kip Viscusi, and Tom Baker (12086) also examine the effects of medical malpractice law reform. While a substantial literature examines the effects of such reform on insurers' incurred losses, Born, Viscusi, and Baker are able to look at longer-term effects. They find these longer-term effects to be especially significant for non-economic damage caps.

Another important category of law is social welfare law, which mandates benefits for children, for individuals who at the age of majority are not able to live independently, and for adults who, though free of any recognized disabil-

ity, have not achieved financial independence. Steven D. Levitt and Joseph J. Doyle (12519) analyze the likely effects of an important mandate intended to protect children—the requirement that children under specified ages (which vary across states in the United States) ride in child safety seats. Using several datasets containing information on auto accident injuries and types of child restraint in use, Levitt and Doyle find that standard lap-and-shoulder seat belts perform as well as child safety seats in preventing serious injury for children aged 2 through 6. Child safety seats, however, are more effective in preventing less serious injury for this age group. Thus, Levitt and Doyle's findings suggest that existing mandates of child safety seats have some effect in reducing injury, though perhaps not the primary sort of effect legislators intended.

Family law is another active area of law and economics research, and changes in divorce law in recent decades have been a particular focus of study. Betsey Stevenson examines the effect on investment in marriage-specific capital of the move to divorce "on demand."⁸ She finds that this change reduced the number of children produced by the marriage, spouses' willingness to invest in their partners' education, and spouses' likelihood of choosing to have one partner remain out of the labor force.

The effects of bankruptcy law have been the subject of several recent papers. Within the United States, both federal and state law are relevant to the bankruptcy process. Recent work by Edward Morrison shows that most distressed firms use state law to liquidate or reorganize and that the attractiveness of state law varies in predictable ways with its nature—and particularly with the degree of transparency of the state insolvency process.⁹ Because the choice between federal and state regimes turns on a comparison of the two, reform of federal bankruptcy law may have unanticipated effects if some firms switch away from the federal regime in response to the reform.

Around the world, bankruptcy regimes exhibit a range of features, and a

recent paper by Simeon Djankov, Caralee McLiesh, and Shleifer explores how the legal rights of creditors in bankruptcy relate to the level of credit extended in a country. In a sample of 129 countries over a quarter century, the authors find a positive effect of legal protection of creditors on the level of credit extended. That effect is observed both in the cross section and longitudinally when a given country expands the legal protection it affords to creditors.

Patent and copyright law govern the circumstances under which inventors and creators will be awarded special property rights. With respect to inventions, patent law requires that an invention be “non-obvious” in order to receive patent protection. Nisvan Erkal and Suzanne Scotchmer suggest that models in which invention is a product solely of investments in research and development fail to capture the full scope of the non-obviousness requirement.¹⁰ In their analysis, invention is a product not only of financial investments but also of scarce, creative ideas. When an idea comes along, a potential innovator faces a choice of whether to invest in the idea or to take the chance that the market niche in question may be filled by someone else who comes along later with a substitute idea. In Erkal and Scotchmer’s model, conditioning the reward for innovation on the level of non-obviousness is shown to be optimal.

A longstanding focus within law and economics has been antitrust law. In recent work, Tomas Philipson and Richard Posner continue in this line

(12132). Philipson and Posner address a basic question: should antitrust law apply in the same way to non-profit firms as to for-profit firms? In their model, not only is there no ground for lesser antitrust scrutiny of non-profit firms, but also in some circumstances the welfare gains from antitrust regulation are greater than in the case of for-profit firms.

In antitrust law as in many other areas of law, the social welfare effects of legal regulation depend in part on the character of market relationships in the absence of regulation. Within the antitrust domain, a major question for researchers has been the degree to which incumbent monopolists can succeed in excluding rivals through contracts with downstream buyers. Complementing a line of important theoretical models analyzing this question, Claudia Landeo and Kathryn Spier offer recent experimental evidence on the use of exclusionary contracts.¹¹ They find that such exclusionary contracts do occur both when downstream buyers are not able to communicate with one another and when they can engage in such communication. Their results complement theoretical models suggesting that regulation of exclusive dealing contracts may be welfare enhancing.

¹ A. Daughety and J. Reinganum, “Products Liability, Signaling, and Disclosure,” NBER Summer Institute Law and Economics Workshop 2007.

² J. Rothstein and A. Yoon, “Mismatch in Law School,” NBER Law and Economics Program Meeting 2007.

³ Y. Watanabe, “Learning and Bargaining in Dispute Resolution: Theory and Evidence from Medical Malpractice Litigation,” NBER Summer Institute Law and Economics Workshop 2006.

⁴ H. Jackson and M. Roe, “Public and Private Enforcement of Securities Laws: Resource-Based Evidence,” NBER Summer Institute Law and Economics Workshop 2008.

⁵ J. de Figueiredo and C. Cameron, “Endogenous Cost Lobbying: Theory and Evidence,” NBER Law and Economics Program Meeting 2007.

⁶ Yair Listokin, “Management Always Wins the Close Ones,” NBER Summer Institute Law and Economics Workshop 2007.

⁷ C. Jolls, “Mandated Medical Leave in the Workplace,” NBER Summer Institute Law and Economics Workshop 2006.

⁸ B. Stevenson, “The Impact of Divorce Laws on Marriage-Specific Capital,” NBER Summer Institute Law and Economics Workshop 2006.

⁹ E. Morrison, “Bargaining Around Bankruptcy: Small Business Distress and State Law,” NBER Law and Economics Program Meeting 2007.

¹⁰ N. Erkal and S. Scotchmer, “Scarcity of Ideas and Options to Invest in R&D,” NBER Law and Economics Program Meeting 2008.

¹¹ C. Landeo and K. Spier, “Naked Exclusion: An Experimental Study of Contracts with Externalities,” NBER Summer Institute Law and Economics Workshop 2008.