



The law and economics of judicial systems

Economic analysis provides a rigorous framework for evaluating the tradeoffs policymakers face when reforming legal institutions. Such analysis reveals that permitting private litigants to determine the amount and kinds of cases the courts hear can impose significant losses on society and shows how the social and private costs of accessing the justice system can be aligned.

The economic analysis of law is an indispensable conceptual tool for designing and reforming legal systems. It does not necessarily deal with markets, prices, and what are conventionally thought to be economic concepts. Rather, it is an approach to analyzing the law and legal institutions that focuses on systematic, empirical analyses of the incentives and effects created by alternative legal constraints.

The economic approach to law

Most work in law and economics has focused on predicting the effects of changes in substantive legal rules. In evaluating legal rules, law and economics scholars are careful to articulate the ultimate social goals and to consider how well these goals are achieved by a particular legal rule, given its predicted effect on behavior. The difference between what the economic analyst of law does and what any intelligent person would do is not necessarily a difference in kind. Rather, it is a difference in the degree of care taken in such evaluative work.

An example helps illustrate the approach. Suppose that policymakers are considering a rule that would require those found legally responsible for causing an automobile accident to pay for any resulting injuries or damage. The first thing the economic analyst of law would want to do would be to predict

the effect this rule would have. Three questions would arise. What effect would imposing liability have on the number of accidents and the number of people who die or are injured on the road? What effect would imposing liability have on the compensation people injured in accidents receive? And what would it cost to administer such a system? In theory there are answers to these three questions. But in fact, because little work has been devoted to addressing these questions, our answers to them are still rough. Still, we have some notion of the answers.

First, statistics do not show that imposing liability has a pronounced effect on the number of road fatalities or injuries. Fatalities and injuries are not noticeably higher in countries where the law does not permit those injured to sue, relative to countries with effective liability laws. This finding suggests that the threat of being held liable for an accident is not what deters most people from driving dangerously. Perhaps they drive carefully because they are afraid of getting a ticket from the police or are worried about being injured in an accident. Whatever the reasons for driving safely, adding the prospect of legal liability does not produce much more deterrence. Another reason may be insurance. Most countries allow drivers to insure

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themselves against losses that they cause from driving carelessly. Such liability insurance considerably eases the financial impact of liability.

Similarly, liability does not have a major effect on average victim compensation. In industrial countries, at least, if there were no liability system, the compensation of accident victims would not be much different. The main reason is the existence of well-developed and widely used insurance systems. Insurance may not cover people for all of the damage awards they could collect in court. But there is no reason coverage could not simply be expanded.

Finally, adopting a rule requiring drivers who cause accidents to compensate the victims would entail enormous administrative costs. In the United States getting \$1 into the hands of a victim through the legal system costs more than \$1. By contrast, the administrative costs of insurance systems are much lower—from 10 to 20 cents per \$1 the victim receives.

These are descriptive statements. One's evaluation of alternative legal rules depends on one's social goals. If social goals include preventing fatalities, compensating victims, and containing administrative costs, then a policymaker might well conclude that a liability system for automobile accidents is not a good idea. This was the conclusion that the people of New Zealand reached in the mid-1970s. They did away with the right to sue—not just for automobile accidents, but for all personal injuries. On the basis of a calculus similar to that described above, they decided to limit citizens' ability to resort to the legal system (box 1).

Law and economics applied to judicial reform

The economic analysis of law can also be a valuable tool in considering alternative models for reform of legal institutions. Three broad principles of reform are suggested by this approach: reducing the scope of the law, simplifying the law, and using incentives to alter access to the legal system.

BOX 1 REDUCING THE DEMAND FOR LEGAL SERVICES: NEW ZEALAND'S ACCIDENT COMPENSATION ACT

In 1972 New Zealand abolished the right to bring lawsuits for most injuries sustained as the result of another person's actions. Instead New Zealanders instituted a system that compensates accident victims from a common fund paid for by a payroll tax. Under the common law tort system it replaced, whether accident victims received compensation depended on a host of factors—such as when and where an accident happened, whether the injurer carried insurance, and the skill of the victim's attorney.

By contrast, the 1972 Accident Compensation Act provides all citizens with 24-hour protection against all accidental injuries, whether they occur at work, on the road, at home, or anywhere else. About 150,000 New Zealanders a year receive financial assistance from the fund to, in the words of a government report on the law, “recover their position in the life and work of the community and meet part of the costs and financial losses caused by the injury.” Even before certain economies

were introduced in 1992, the system cost less than NZ\$1 a day (about US\$0.5) per capita.

A review of the system by a former prime minister who was one of its architects concluded that taking personal injury cases out of the courts had been an unqualified success:

International comparisons suggest that the scheme has been highly economical . . . The coverage is comprehensive, the cost relatively low, and the lessening of human suffering clear . . . Experience from overseas clearly indicates that common law fault based systems of compensating injury are economically inefficient, expensive, discriminatory, and drawn out . . . The New Zealand scheme allows many more people to claim for their injuries than ever tort law alone did . . . Abolishing tort law personal-injury cases in New Zealand has been a success. The welfare of New Zealanders has been increased by it.

Source: Palmer 1994.

Reducing the scope of the law

Reformers and social planners should always consider the possibility of reducing the scope of the law. Reducing the demand for legal services can free much human talent for other things—the practice of medicine, the construction of roads, and so on. People trained in law often stress rights and may not weigh the costs of expanded rights against their benefits. Yet developing countries cannot afford to squander human and economic resources adjudicating complaints that are not important or that the law may not do much to redress.

Simplifying the law

Legal rules can become very complicated. Simplifying them may save scarce resources. One way to drastically reduce the amount of litigation is to use predetermined schedules or tables to calculate the damages that accident victims can collect rather than making the amount a subject for legal adjudication. This is the approach many countries take when determining the compensation for on-the-job injuries. Does using tables lessen the deterrent much? Probably not.

As for victim compensation, those worried about being undercompensated by the courts can always supplement their insurance coverage by buying additional coverage. In many cases simpler is better—especially when resources are scarce and the marginal social benefits to increased complexity are slight.

Altering access to the legal system

What access should people have to the legal system? Should people be able to sue whenever the amount that they would have to pay their lawyer to bring the suit seems worthwhile to them, given the odds of winning? There are important externalities to the use of legal services, and policymakers should not allow private actors alone to determine when they want to bring suits. Sometimes it is a good idea to impose fees or otherwise discourage people from using the legal system. At other times one might want to encourage people to sue by subsidizing litigation. An example illustrates each case.

The first is extremely simple. Imagine that automobile drivers are not deterred at all by lawsuits. Suppose also that society is not getting any benefits from victims being compensated through lawsuits because everyone has accident insurance. This is a situation in which suits should not be brought, because suits would only squander legal resources. But suits will be brought anyway. Many accident victims will think that they can win a suit and collect a lot of money. They might know intellectually that bringing a suit will squander social resources—but many will probably still do it, because otherwise they would be passing up free money. Of course, the world is not so simple. But the point of this stark example is to show that an individual's calculus in deciding whether to bring suit is very different from the calculus a social planner would want the person to engage in. In some cases extra fees or other barriers to discourage private suits are warranted.

The second example is one where people do not sue but it would be good if they did. In this instance a case can be made that lawsuits should be subsidized. Suppose that a potential injurer can eliminate the possibility of an otherwise very likely harm causing \$1,000 in damages by spending a nickel. Suppose, though, that it would cost a victim \$2,000 to bring suit, but if victorious the victim would only recover the harm—\$1,000. In this situation no one would bring suit, because the victim would have to spend \$2,000 to win \$1,000. The consequence of no one bringing suit is that the original actor would say, “Well, I could spend a nickel to eliminate this \$1,000 harm, but why should I? I’m never going to be sued, so I might as well save my nickel.” But if the government subsidized the suit, then the potential injurer would say, “If I cause this harm of \$1,000, I’m going to be sued, because the victim will be subsidized. Since I don’t want to pay \$1,000 in damages, I’ll spend the nickel to eliminate the possibility.”

The willingness of the state to subsidize the suit solves the problem entirely, because it induces potential injurers to take precau-

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tions to eliminate harm. The result is that the suit never actually occurs. Again, in the real world things do not work this simply. But it is still easy to generate realistic situations in which people do not have the financial incentive to bring suit—but if they were induced to bring suit by subsidy, it would change the behavior of other actors for the better.

There are many areas in which it would probably make sense to shuffle the volume of litigation in one direction or the other. These interventions should be determined by policymakers based on social goals and the specifics of each situation. Society simply has too much at stake to let the amount of litigation be determined solely by private actors.

Further reading

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Years On.” *University of Toronto Law Journal* 44(2): 223–73.

Shavell, Steven. 1987. *Economic Analysis of Accident Law*. Cambridge, Mass.: Harvard University Press.

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This note is based on a talk delivered by Steven Shavell (Professor of Law and Economics and Director of the Center for Law, Economics, and Business at the Harvard University Law School) on February 9, 1999, at a PREM seminar on judicial reform.

If you are interested in similar topics, consider joining the Legal Institutions Thematic Group. Contact Geoffrey Shepherd, x31912, or Richard Messick, x87942.



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