ECONOMICS, LAW AND "LAW AND ECONOMICS"[1]

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I

In Ancient Greece, modern sciences converged into a parent science: philosophy. As thinkers delved deeper into certain subjects, independent sciences gradually emerged. Greek philosophers were primarily interested in justice and happiness. This is why their main writings were related to moral issues, justice, and political systems. However, they also reflected on physics, history, astronomy, rhetoric, etc.

Economics is a spinoff of law, and law is a spinoff of philosophy. The initial reflections on economic issues were related to matters of justice. For example, Greek philosophers questioned what the "fair price" of goods was, but they did not inquire about how a price was set. They also wondered if it was fair to charge interest on loans or make profits in trade, but they did not reflect on how interest rates or profits were fixed. To answer these questions, they delved into the subject of currency, reflecting on its nature and functions.

Of all Ancient Greek philosophers, Aristotle determined the evolution of thought for many centuries. Whether we agree or not with his findings, they paved the way for a long process of evolution in economic thought for almost 2,000 years.

II

Aristotle was very imprecise in his remarks about the "fair price," and his condemnation of interest charges and profits in trade lay upon fallacious concepts about the nature of money and exchange. There is a legend about the fate of Aristotle's "books" after his death. They remained hidden for many years, damaged by moisture. But when the Romans invaded Greece, they found the works in the house of a wealthy merchant who had attempted to reconstruct, without much understanding of philosophy, the erased parts. The works were taken to Rome and kept under careful guard. Until then, Aristotle's teachings had been passed by word of mouth, so the discovery of the papyri sparked great curiosity to see if what was taught verbally matched with what the Greek philosopher had written.

Only in the 13th century, with the involvement of Saint Thomas, the works were reconditioned with greater academic authority. Aristotle had left many unanswered questions regarding justice in exchange. Saint Thomas and the scholastics who followed him began to delve into the topic of justice in exchanges. To answer what a fair price is, such deepening compelled the scholastics to inquire about what is it, how is it fixed, and why the price of a good varies. They had to do the same regarding interest rates and trade.

In this way, and to answer the questions about the issue of justice, economic theory[2] began to slowly emerge. The concepts of supply and demand[3] began to surface to explain the phenomenon of pricing. For example, following the tradition of St. Albert the Great and Saint Thomas, the early scholastics argued that the fair price was determined by the cost of production of goods. In contrast, the late scholastics, especially those linked to the School of Salamanca, argued that the price was set by necessity and scarcity. Thus, the former suggested that rulers set the fair price of goods bearing in mind the cost of production, and the latter suggested

[1] Translation by Carolina G. Rodriguez.

[2] Although in Europe, scholastic thought ruled and had an undisputed influence, it is worth remembering that the Arabs and Israelites followed a very similar path. They also addressed economic issues from a standpoint of justice. However, the scholastics progressed much more rapidly in developing economics theory to counter the problems of justice. Among the most important scholastic authors, we find Martín de Azpilcueta, *Comentario resolutorio de cambios*, Consejo Superior de Investigación Científica, 1965. Tomás de Mercado, *Suma de tratos y contratos*, Editorial Nacional, 1975. Luis de Molina, *La Teoría del Precio Justo*, Editorial Nacional, 1982. For a detailed history of the subject, see Marjorie Grice-Hutchinson, *El pensamiento económico en España*, *1177-1740*, Editorial Crítica, 1982; Raymond de Roover, "El concepto de precio justo: teoría y política económica*", Estudios Públicos,* vol. 18, 1985 (originally published in the *Journal of Economic History*, vol. 18, 1958; a very comprehensive work is that of Alejandro Chafuen, *Christians for Freedom*, Ignatius Press, 1986.

[3] The vocabulary used was that of "many (or few) buyers" in reference to what we now call demand, or sellers as to what we now call supply. It was also referred to as the urgency or need to sell or buy.

considering scarcity or necessity. This way of solving the problem of justice led them, then, to the emergence of the first economic theories, which were, obviously, very rudimentary, but they achieved a great task: creating the conditions for the future birth of economics as a science. It can be said that throughout the Middle Ages, economic theory was underneath a problem of justice or morality.

III

The refinement and expansion of these prices, interest rates, and exchange theories slowly gave rise to a more complete and complex theoretical framework.

For a long time, it was claimed that Adam Smith was the father of economics. If by "father" one means the first to have said something regarding economic matters, or to have written a comprehensive and systematic treatise, the title does not apply to him. But if by "father" we mean the one who warned about the importance of these theories for explaining how markets work regardless of justice, then the title is well-deserved. With Adam Smith, economic theory gained importance and popularity, and in some ways, it can be said that it became an independent science.

However, Adam Smith was not an economist; he was a moral philosopher. His book "Theory of Moral Sentiments" (preceding "Wealth of Nations") and his "Lectures on Jurisprudence" (a compilation of his classes in Scotland, also preceding "Wealth of Nations") show that Adam Smith, like Aristotle, was versed in a field of knowledge committed to moral and justice problems.

Adam Smith's great advantage, as well as that of a large number of classical economists, was his "global" vision of the market process, which bears within a legal framework. The same can be said of John S. Mill, who brought classical economics to its peak of popularity. Mill's thinking, like Smith's, complemented economic theory with the general principles of a free society; or it might be better to say that it complemented the principles of a free society with an economic theory in line with them. This way, classical economists were able to develop a much more fruitful economic theory than mathematical economics developed since the late 19th century. They could explain more thoroughly the economic effects of changes in legislation. Statements like Adam Smith's assertion that capitalists rarely meet without conspiring to achieve privileges are a good example of how human incentives were linked to legislative proposals that benefited some groups at the expense of others. The effects of tariff protections were also analyzed not only in terms of their economic effects but in terms of privileges and violations of individual rights as well.

Karl Marx himself followed the same line of reasoning. There are many more similarities between Marx and the classical economists than those many believe can be found. Both classical liberals and Marx felt some sort of disdain for businesspeople. The difference between them lies in the fact that classical economists wanted to solve the problem by making businessmen compete on equal terms, while Marx believed the problem lay in private property.

IV

Classical economists' economic theory was inconsistent due to the lack of a theory of value.[4] This deficiency made their price theory inconsistent. The problem was solved by including the marginal utility theory as the foundation of price theory, in the late 19th century.

However, the marginal utility theory led to a methodological division in economics. Such theory was developed by three groups: (1) in England, by William S. Jevons and Alfred Marshall; (2) in Switzerland, by Leon Walras, Vilfredo Pareto, and later by Gustav Cassel; and (3) in Austria, by Carl Menger and Eugen von Böhm-Bawerk. The first two groups gave rise to mathematical economics, primarily because those thinkers had a background in mathematics rather than in moral or political philosophy as the classical economists did. In contrast, the third group, composed of lawyers, continued the theoretical line developed by the classical economists. However, the marginal utility theory allowed them to overcome the inconsistency of the classical economists' price theory.

[4] It is not true, as is generally believed, that the classical economists had a labor theory of value, and this is false even in the case of Marx. Neither the classical economists nor Marx had a theory of value; they only had a price theory based, indeed, on the cost of production or on labor. For further details, see Juan C. Cachanosky, "Historia de las teorías del valor y del precio", *Libertas*, May 1994 and May 1995
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The mathematical economics that later predominated in the academic world of the 20th century diverted almost entirely from the legal framework that was always present in classical thinkers. The Austrians, on the other hand, continued to develop both economic theory and the legal and political frameworks that enhanced or diminished the benefits of the market.

In the case of Ludwig von Mises, his book "Socialism" is a treatise on property rights. The book "Liberalism" is another example of the complementarity between economic theory and the legal-political frameworks required for the economy to maximize its positive outcomes. In the case of "The Anti-Capitalistic Mentality," he shows (as Adam Smith did) the incentives individuals have in favor of introducing regulations for the performance of the market. Finally, his magnum opus "Human Action" is a treatise on economics in the classical style but with a solid epistemological foundation, where human action (or as he called it: praxeology) is grounded in the application of property rights. In other words, his economic theory retorts to a specific legal framework.

The case of Friedrich A. von Hayek may be even more forceful since this thinker wrote a significant number of treatises and articles on legislation, law, and politics. "The Constitution of Liberty" and "Law, Legislation and Liberty" are clear examples of the advances made by the Austrian School within the classical tradition. Perhaps Hayek, more than Mises, emphasized the consequences of inadequate legislation for the performance of society and the economy.

V

Law and economics are not two independent sciences. On the contrary, they are two sides of the same coin. The market is nothing more than the exchange of property rights, something that requires contracts and, therefore, demands a legal system that facilitates or hinders these contracts. In other words, it requires a legal system that either enhances or weakens exchanges.

Laws have consequences on the actions and incentives of individuals. Therefore, they have consequences for exchange and the efficient performance of the market. A jurist who ignores how the market works has no idea of how legislation affects the economic well-being of the population. Similarly, the economist who ignores the fundamental principles of law has no idea about the legal framework implicit in his theory.

For an extensive time, economics was studied within the field of law, and perhaps for this reason, ancient lawyers had a better understanding of the market than mathematical economists did. The great paradox of mathematical economics is that in seeking "accuracy," it produced theories that were sterile but mainly inconsistent.[5]

VI

For all the above, it could be said that the "birth" of Law & Economics as developed by the Chicago School, is not really novel. Or perhaps it may be novel for mathematical economists who, for a long time, remained distant from the legal framework implicit in their models.

However, I would also like to raise some doubts about this line of thought. The underlying idea of the law and economics is to assist judges in solving conflicts by applying economic theory tools. In this, I see two problems:

> (1) The economic theory generally proposed for solving conflicts is the neoclassical economy, which is fundamentally mathematical economics, or conventional microeconomics, if you will. The problem is that, as mentioned earlier, this theory is inconsistent. The concept of "efficiency" is logically and mathematically mistaken.[6] As the standard the judge must meet to decide legal cases is a “cost-benefit” one, he or she will be using an inconsistent standard.
> (2) Nevertheless, one could argue that this is a problem that can be solved if judges abandon the inconsistent theory and adopt a consistent one. But this leads me to the second objection.

[5] It can be proven that the concept of efficiency reached by mathematical economics is inconsistent from a mathematical perspective, and therefore, the theory becomes false from a logical and factual standpoint. See Juan C. Cachanosky, "Certainty, Uncertainty, and Economic Efficiency," *Laissez-Faire*.
[6] Setting aside the unrealistic assumptions on which it generally relies.

> Does economic analysis serve the purpose of deciding what is fair or unfair? Or does it serve the purpose of fixing the "penalty" that the losing party of the conflict must pay? One of the solutions these thinkers often reach is that if there is no disruption in the allocation of productive resources, that it does not matter which party bears the costs. However, there "necessarily" has to be a reallocation of productive resources. It is not indifferent to the allocation of resources which of the parties pays the costs of the dispute.

VII

To serve justice, it may seem that judges have two types of problems: (1) cases of voluntary contracts between parties and (2) criminal cases where there is compulsion from one party towards another.

In the case of voluntary contracts, judges only need to ensure that the parties fulfill what was agreed upon. A problem could arise if the contract is not clear or does not cover a particular issue. In that case, the judge must rely on some basis (such as customs and practices) to ascertain which party is right. Perhaps economic analysis is useful in this case to establish the amount of the penalty (assuming the penalty is pecuniary), but it does not seem useful for determining which of the parties is breaching the contract. It is obvious that implicit contracts in a society, which are based on customs and practices, should also be included in this group.

In addition to contracts and customs, judges must enforce laws.[7]

Criminal cases are different; there is no agreement between the parties. On the contrary, someone is assaulting the life, liberty, or property of others.

As there is no contract establishing rights and obligations, someone has to determine when individual rights are being violated. This can be done through a written law or on a case-by-case basis, where it is to be determined whether a crime has occurred and, if so, whether the accused is guilty or not.

Criminal cases are more complex than contractual ones, in the sense that crimes not only affect the assaulted victim. It also affects the rest of society as well (hence the role of the prosecutor). A thief, a kidnapper, a rapist, or a murderer attacks the rights of one or several individuals, but they also become a potential danger to the rest of society.

One can defend against individuals who do not fulfill contracts by not engaging in any transactions with them, simply because voluntary agreements are required. But in criminal cases, and due to compulsion, this self-defense mechanism does not apply. The only recourse left to prevent future compulsive actions is imprisonment (or the death penalty).

VIII

As Ludwig von Mises said, economics is an aspect or a portion of a more general science: praxeology, or the science of human action. Economics studies human actions that cause monetary prices.

Those human actions lead to exchanges of all kinds between people. Those exchanges can be voluntary or compulsive. If exchanges are voluntary, both parties win (or more precisely, the parties engage in voluntary exchanges because they "believe" they will improve their present situation). In compulsive exchanges, one party wins, and the other loses.

The role of the State in a free society is to ensure that there are no compulsive relationships.[8] The essence of a free society lies in voluntary exchanges.

But for exchanges to be voluntary, certain conditions, which we can call basic rights of individuals, must be met. These are the rights to life, liberty, and property. Since this is not included in any contract, it is assumed that a declaration of rights or a constitution admits these fundamental rights which no one (not even the State, as it would contradict its function) can transgress.

Criminal cases consist of the violation of these basic rights. Compliance with these rights is foundational for individuals to engage in voluntary exchanges (which may or may not cause monetary prices).

[7] In another article, I analyzed the advantages of an unwritten or non-contractual legal system compared to written legislation. See Juan C. Cachanosky, "Economic Efficiency and Legal Systems," *Revista de la Facultad de Derecho*, Francisco Marroquin University. However, for a more authoritative explanation, refer to Bruno Leoni's *Freedom and the Law*, Nash Publishing.

[8] Or, if one wishes to "minimize" the number of compulsive relationships, bearing in mind that perfection does not exist.

Respecting these basic or individual rights, through voluntary agreements, allows the emergence of voluntary rights and obligations. For example, individuals have the right to life, liberty, and property, but they do not have the right to education or health. However, respecting individual rights allows them to enter into contracts to be educated or healed. When parents enroll their child in a school or university, they are entering into a contract whereby both parties acquire rights and obligations. These rights and obligations arising from the contract do not exist without a prior voluntary agreement between the parties. It is the individual rights sanctioned by the constitution that allow the creation of new specific and not general rights and obligations. Similarly, if a person hires a prepaid health plan service, they acquire rights and obligations that they would not otherwise have.

In this way, we can distinguish people's rights into two broad categories: (1) basic or individual rights to life, liberty, and property and (2) "created" rights. The first ones are inherent to the individual by birth and are essential for them to act freely. The second ones are not possessed but are acquired through free contracting.

The role of the State in a free society is to prevent compulsion by one or more individuals against others. The State does not create the law but enforces it. Individuals create the law when they voluntarily agree to rights and obligations. A golden rule should be that no one can do through the State what they cannot do directly. Or, in other words, the State cannot perform any action that a person cannot legitimately perform. Violating this principle leads to contradictory consequences. For example, no businessman can force others, by the use of weapons, not to buy products from abroad. However, if the same businessman manages to have the State do the same through customs, then the action becomes "legal." The original victim becomes a criminal (a smuggler), and the original offender becomes a victim (of foreign competition). Another example is that no worker can make others, by force, give a portion of their wages. However, if the State makes associating with workers' unions mandatory, then the crime becomes "legal." The original victim becomes a criminal because he or she avoids making the "legal" contributions, and the original offender becomes a victim because he cannot defend the workers' "rights".

IX

We could conclude that economic analysis of the law can be an additional tool for deciding legal cases in some particular instances. Nevertheless, the principles of ancient Roman law and English common law seem to be more fertile in determining which party is at fault. Law and Economics, as developed by the Chicago School, appears to be more useful for ascertaining the amount of penalties than for stating which party is right. However, even in this case, costs are subjective, so the utility of determining penalty amounts can also be distorted by this issue. Unless the penalty is stipulated in the contract, its resolution is always subjective. In this case, Law and Economics may serve as a convention to establish penalty amounts without falling into judges' subjectivity.