The Second Wave of Law and Economics

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The Federation Press
1999

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Law, Economics and Judicial Decision-making

The Right Honourable Sir Ivor Richardson [1]

1. Introduction

The great American judge, Justice Holmes of the United States Supreme Court, foresaw the development of modern law and economics 100 years ago when he said that:

> For the rational study of the law the black letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics. (Holmes, 1897)[2]

Economics has long been accepted as centrally relevant to legislative and executive decision-making (see, for instance, Rose-Ackerman, 1996; Barker, 1996) but there has been less acknowledgment of its role in the judicial sphere. There are two features of the legal system which, in my view, make economic analysis of law an important field of study for the courts. The first is that the courts allocate and reallocate resources and their decisions necessarily affect the use of society's limited resources. Justice may be priceless but it is not costless. The acceptable resolution of disputes may involve balancing human rights and other values. But the efficient use of scarce resources and the economic implications of suggested alternatives can never be ignored, just as in the decisions we make as individuals as to how we will spend our energies and our money there are always policy trade-offs between efficiency, fairness and other individual and community values. The second feature is related to the first. Like economics, the legal system is concerned with behaviour. It seeks to influence behaviour by establishing rules of conduct and imposing sanctions for their breach. Therefore it is only logical to conclude that rules and sanctions should be designed and decisions made having regard

1 President, Court of Appeal, New Zealand.

2 "*The Path of the Law*, originally delivered as a speech on January 8, 1897, is generally considered to have heralded the beginning of the modern era of American jurisprudence": Sebok, 1997, p 1.

to the incentives they create and the impacts these will have for the allocation of resources for the future.

Although much has been written about economic analysis of law, there is still very little published empirical research and analysis of our laws and their administration. It is much easier to rely on intellect and to engage in intuitive reasoning in drawing conclusions, rather than to get out on the ground and try to ascertain what happens in practice and explore the costs and benefits of legal rules and administrative approaches. Some economic analysis can be subject to the same criticism. But empirical analysis is crucial in any public policy inquiry, including in the courts. In that inquiry, the links between the disciplines of economics and law need to be emphasised and made more sophisticated rather than be seen as boundaries beyond which it is not necessary to travel. One of the most useful features of the second wave of law and economics, in my view, is its focus on empiricism (see, for instance, Dewees, Duff and Trebilcock, 1996; and generally Cooter and Ulen, 1997). But regrettably, when it comes to particular cases that judges must deal with, relevant empirical data and other material that would aid a consideration of the resource implications of our judgments is still often not placed before the courts. The scope for increased use of empirical information to aid the use of economic analysis in the courts is the particular focus of this chapter.

2. The scope for economics in judicial decisions

It is true that in the great majority of cases before the courts there is no scope for economic or for that matter any other theoretical perspective of the law. The applicable legal principles are already settled, or the statute is clear. But in some cases there is room for divergent answers. This is true both at common law and under legislation. The direction of development of the common law depends on what analogies are used and on an assessment of the underlying values involved. In some cases the courts are called on to consider whether an existing rule should be replaced as no longer meeting the public interest or what rule should be adopted to address a new situation or circumstance. In exploring what legislation means, the courts are required to consider the public policies which the legislation serves. Where there has been a great deal of economic and social change, as in New Zealand and Australia over the past 10 years, it becomes all the more important to take stock of our laws, to inquire whether they address the values of today's society, and to understand their economic and social implications. In these contexts, intuitive assessments

of the public interest are likely to be improved to the extent that they are supported by hard facts.

Such analysis is not restricted to the traditionally "economic" areas of the law. Economists and lawyer economists are familiar with the use of economic concepts and the use of economic analysis in what has been called the "old" law and economics. Obvious examples are competition and securities regulation, planning and resource use, and valuations for various purposes. Some tax cases too, such as those involving the assessment of "income" for tax purposes, transfer pricing and international tax questions, necessarily require economic analysis. Statutes such as the New Zealand *Commerce Act* 1986 or the Australian *Trade Practices Act* 1974 (Cth) are explicitly written in language that calls for economic analysis and make provision for economic experts to give evidence and even to sit on the court, or, in Australia, on the Trade Practices Tribunal. By contrast, new law and economics seeks to apply the concepts and techniques of economics to the analysis of other areas of the law, such as contract law, tort law, property law, constitutional law – areas where economic efficiency may be far from explicit in the law itself (Brunt, 1984, p 113; see also Veljanovski, 1982, p 7).

That is not to say that economic analysis in the "old" areas is necessarily straightforward. The New Zealand Telecom-Clear litigation, culminating in the recent Privy Council decision in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385, highlights the problems that may be involved, and the disagreements that can arise even among economic experts on the appropriate principles to be adopted. In other cases there may be differences of view as to whether there is scope for economic analysis at all. This may explain the different perspectives of the New Zealand Court of Appeal and the Privy Council in *CIR v Mitsubishi Motors Ltd* [1994] 2 NZLR 392 (CA); [1995] 3 NZLR 513 (PC). The issue in that case was whether a taxpayer could take account of anticipated expenditure on warranties in future tax years as disclosed by accounting estimates in respect of cars sold during the year of assessment. The Court of Appeal held that liability arose upon the occurrence of a contingent event and therefore, on the construction of the narrowly framed deductibility provisions in the statute, it was not expenditure incurred in the year the car was sold. However, we went on to hold that, because the contingency remained outstanding at the date of sale, it could not be said that the income arising from the sale of the car had yet been wholly earned. Therefore only a proportion of the sales revenue was assessable income of that year. Our reasoning here was influenced by the fact that under ordinary accounting principles and

commercial practice the income would not have been treated as fully accrued as long as the contingency remained outstanding: [1994] 2 NZLR 392 at 397. The Privy Council, on appeal, adopted different reasoning, holding on a different interpretation of the deductibility provisions that the warranty costs were deductible expenses. In the circumstances, it was reluctant to construe the term "income" as anything less than gross receipts. Here the Privy Council saw itself adopting "a jurisprudential rather than a commercial view of the meaning of incurred": [1995] 3 NZLR 513 at 517.[3] Given the debate that may exist as to whether and to what extent economic principles are relevant to the "old" areas of law, it is understandable that there may be differences of view as to its relevance to areas of law where the role of economics is even less clear in the way the law is framed. Nevertheless, economic thinking can and has made significant contributions to the development of "new" areas of the law as well as the "old" and that contribution is ongoing.

There are two ways in which law and economics, and in particular empirical analysis, can aid judicial decision-making. First, at the positive level, the analysis may be employed to better understand the economic impacts of existing rules and to enable responses to proposed policy changes to be predicted. The value of empirical data and other material for effective positive analysis is quite clear. Second, at the normative level, the analysis may be used to ask whether a particular rule or policy should be confirmed or adopted on the basis that it represents the most efficient use of society's resources. In the Chicago School, normative economic analysis has tended to reflect the assumed virtues in many contexts of the private exchange or market process over collective methods of resource allocation (see, for instance, Posner, 1992, p 15). It is this kind of use of economic analysis in determining economic and social policies that has attracted very mixed responses and the Chicago label is often used pejoratively to dismiss the whole of law and economics as right-wing ideology. However, a normative approach need not be driven by right-wing ideology. It is in this context that a greater reliance on empirical data and material may be particularly valuable for judicial decision-making. To the extent that any "normative" judgment about the appropriate direction of the law is firmly embedded in empirical analysis of the benefits and costs of the proposed direction versus alternatives, it may suffer from a lesser degree of controversy than one which adopts as its starting point various untested assumptions in favour of private exchange or the market.

3 The *Mitsubishi* case and several other recent tax cases decided by the Court of Appeal are discussed further in Richardson, 1998.

3. Experience with economic analysis in cases

In the following discussion I draw on my experience as a Court of Appeal judge in New Zealand to show how empirical evidence was useful in reaching our conclusion in a number of cases. I also refer to other cases in which the absence of empirical evidence made it difficult for us to evaluate the economic impacts of our judgment or to draw normative economic conclusions about the appropriate direction of the law.

3.1 Contract cases

The first case I want to mention involved a claim for consequential loss arising from misdelivery of a package by a courier firm. The airbill described the contents as documents of no commercial value. The package contained a bearer bill of lading which enabled the holder to obtain possession of goods. The holder went bankrupt and the goods were not recoverable. The exporter, Richmond, sued the courier, DHL. The courier's contract was to deliver the package to Italy, and for $22.50. Not surprisingly the standard form contract contained exclusion and liability limitation clauses and time bars. Separate insurance was available at the shipper's option, but Richmond had not elected to take out insurance in this particular case. In the Court of Appeal we disagreed with the finding at first instance that the exclusion and limitation clauses should not be given effect: *DHL International (NZ) Ltd v Richmond Ltd.* [1993] 3 NZLR 10. As we said:

> The capitalised heading to cl 7 [CONSEQUENTIAL DAMAGES EXCLUDED] re-emphasises the statement on the front of the airbill excluding liability for consequential damages. In its terms the clause could hardly be expressed more widely and clearly. DHL is not to be liable "in any event" for any consequential or special damages or other indirect loss "however arising".
>
> That was the basis on which the parties contracted. The exclusion of any such liability is entirely consistent with the scheme of the contract as a whole. It is entirely consistent with the agreed allocation of risk including the implicit assumption by Richmond under cl 5 of the loss of the commercial utility of the documents. The parties contemplated the possibility of misdelivery or non-delivery of the package and provided their own liability regime. The exclusion and limitation of liability provisions conform with the object of the transaction, namely of providing a cost-effective delivery service where the price charged reflects the responsibilities and risks undertaken by each party. To read down the unqualified breadth of the exclusion clause would involve rewriting the contract and

> transferring to the courier what is properly a commercial risk accepted by Richmond as part of its costs of doing business. (pp 21-22)

The significance of the case, viewed from an economic perspective, is not so much in the particular outcome as in the approach adopted to the reasoning. That is, the emphasis on the factual matrix, on the contractually agreed allocation of risks and responsibilities, and on the commercial appropriateness of that agreed allocation. In the past English, Australian and New Zealand courts have sometimes tended to view standard form contracts and exemption clauses, in particular, with suspicion as the products of inequality of bargaining power and imperfect information available to weaker parties, at the very least construing them narrowly: see, for instance, *Livingstone v Roskilly* [1992] 3 NZLR 230 at 238-39 per Thomas J. But, given that the exemption clause in the *DHL* case was worded clearly, we did not need to adopt a view as to how it should be construed. The case illustrates that empirical analysis may not warrant a critical approach on the part of the courts. Standard form contracts can potentially increase efficiency by permitting a dramatic reduction in transaction costs and so in prices (Trebilcock, 1993, pp 119-20). It may be that the particular market may be disciplined by the competition afforded by buyers who understand the terms and can negotiate or switch to other suppliers offering more favourable terms. That seemed to us to be the case in the market for courier transport. Further, Richmond was provided with the option of purchasing insurance for its extraordinary losses, at a higher price, but chose not to do so. In those circumstances, the reality is that intrusion by the courts on the operating of markets tends to add to the cost of the goods or services.

The *DHL* case, however, provides the exception rather than the norm in the use of economic analysis in contract cases. In respect of contractual remedies, for instance, there has been no attempt to question the legal treatment of stipulated remedies as "penalties" on the basis that in reality they reflect a high subjective value placed on performance and a judgment that the party in breach may be the best possible insurer of the loss of that value – even though the judicial suspicion of penalties has often been criticised in the economic literature (see, for instance, Cooter and Ulen, 1997, pp 213-14). Judicial interference with the contractual arrangements of the parties – in New Zealand, under statutes such as the *Contractual Remedies Act* 1979, *Credit Contracts Act* 1982, *Fair Trading Act* 1986 or the *Illegal Contracts Act* 1970 – might also be muted if it were shown that the likely long run effect is to increase costs and prices for the supply of such goods and services, so that it is less likely that disadvantaged

sections of the community will have reasonable access to goods and credit. Yet no reference was made to any such information in the Law Commission's report on the *Contracts Statutes Review* (NZLC, 1993). And we have never had any material of that kind referred to us in any of the cases we have had to deal with. However, at times we have been able to draw on published empirical information in our judgments. For instance, in *House v Jones* [1985] 2 NZLR 288 we used movements in the Consumer Price Index to show that it would be unjust to allow the purchasers to complete a 1980 transaction paying in 1985 dollars. In the result the purchasers were refused relief under the *Illegal Contracts Act* 1970 for breach of the *Land Settlement Promotion and Land Acquisition Act* 1952.

3.2 Tort cases

Torts may be viewed as supplementing contract law by devising rules for allocating or spreading losses in situations where it is too costly for potential injurers and potential victims to enter into contractual relationships with each other to make that allocation. In classical legal theory the tort of negligence involves the defendant's breach of a duty of care to the plaintiff. The normative economic goal of tort law is that tort liability should be structured so as to minimise the sum of precautions, accident and administration costs (Calabresi, 1970, pp 26-28). The economic approach is reflected in leading cases on the negligence standard in Australia and New Zealand: see, for instance, *Wyong Shire Council v Shirt* (1980) 146 CLR 40 (HC) at 46-47 per Mason CJ; *Fleming v Securities Commission and Taranaki Newspapers Ltd* [1995] 2 NZLR 514 (CA).[4] Recently, we reiterated the relevance of economic policy considerations in framing the character and scope of tort liability in the context of an action by a company against the Auckland City Council for damage caused to its property by a burst water main. The Council argued that it had not been negligent and that, following the High Court of Australia's decision in *Burnie Port Authority v General Jones Pty Ltd* (1994) 179 CLR 520, the rule in *Rylands v Fletcher* (1868) LR 3 HL 330 is no longer good law in New Zealand. We emphasised that such an assessment would require consideration of the likely economic and social implications of alternative legal rules: *Autex Industries Ltd v Auckland City Council* CA 198/97,

4 American courts – which have traditionally been far more receptive to economic analysis than Anglo-Australian courts – have long accepted the value of an economic approach to determining questions of tort liability: see *US v Carroll Towing Co* 159 F 2d 169 at 173 (2nd Cir, 1947) per Learned Hand J.

unreported judgment, 23/2/1998. A majority of us did not feel we needed to go further, given that the application was for summary judgment with the onus on the defendant to satisfy the court that its defence involved clear cut questions of law and did not require findings of disputed facts or the ascertainment of further facts. Keith and Blanchard JJ were prepared to go further in defending the current strict liability regime of *Rylands v Fletcher* in economic terms (at p 10 of their judgment):

> The payment of damages to those injured by non-negligent failure of a public water system ought to be a cost of running the system. The local authority can determine the relative economics of expenditure on preventing escapes, meeting insurance costs or paying compensation ... The risk of calamitous loss to a neighbour, who is necessarily unable to forestall an escape occurring on adjacent property, ie who is unable to manage the risk, is spread among all ratepayers or is borne by the local authority's public liability underwriter. Such a rule of strict liability protects those who may not be able to obtain insurance (eg owners of undeveloped land) or who have misunderstood the need for it, perhaps because they are unaware of the presence of underground mains. It also minimises any doubling up of insurance premiums. (Those able to obtain insurance still need it lest the escape of the dangerous substance results from the act of an unknown or impecunious third party unaccompanied by negligence on the part of the council, but the slightness of that possibility will be predicted in minimal premiums.)

In such cases empirical information may be particularly valuable in supporting economic arguments. Thus in *South Pacific Manufacturing Co Ltd v NZ Security Consultants and Investigations Ltd* [1992] 2 NZLR 282 we held that policy considerations told against imposing a duty of care in tort towards the insured on the part of a private investigator appointed by the insurer to report on a suspicious fire. The primary policy consideration so far as I was concerned was that any claims could and should be pursued down the contractual chain. I commented:

> These were commercial premises and commercial insurance contracts are frequently negotiated through brokers. The amount of the premium is the price paid for the particular cover agreed. If the insured have a remedy in contract against the insurer they should exercise that remedy. If they do not have an adequate remedy that is because they only paid a premium which gave them that lesser protection. In that situation I cannot see any justification for allowing them a greater recovery through tort than they were prepared to pay for in contract.
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> The second contract is between insurer and investigator. There, too, the parties have their expressly or impliedly agreed remedies for any

> negligence in the performance of the contract *(Gold Star Insurance Co Ltd v Dominion Adjusters Ltd* [1982] 2 NZLR 38); and in the absence of an exclusion of liability the duty of care applies both to the work of the investigator which results in the report and to the report itself. (p 308)

I added that it was not suggested in argument, and nor was there any evidence to suggest that, that through oligopolistic trade practices or other market failure the parties to such commercial insurance arrangements could not be expected to arrive at commercially acceptable bargains. Nor was it suggested that state intervention through the imposition of legal obligations in tort was required in the public interest to redress that kind of imbalance.

There are other areas where we might well have benefited from a greater, or at least more rigorous, use of economic analysis and empirical evidence in tort cases. For instance, there have been several negligence cases in the 1970s and 1980s, in the United Kingdom and New Zealand, in which the courts imposed duties of care on local bodies for the carelessness of building inspectors: *Anns v London Borough of Merton* [1978] AC 728 (partly overruled by *Murphy v Brentwood District Council* [1981] 1 AC 398); *Mount Albert Borough Council v Johnson* [1979] 2 NZLR 234 (CA); see also *Council of Shire of Sutherland v Heyman* (1985) 157 CLR 424 (HC).[5] The unexpressed assumption was that the economic burden of careless advice and omissions on the part of employees of local bodies would be passed on to ratepayers. It would have been extremely useful to have had an analysis of the likely impact on society of those developments. How would local bodies be likely to respond, and what would be the longer run economic and social consequences. If local bodies simply added the costs to ratepayers, whether directly or through insurance, how would that affect the behaviour of local body employees – and of builders and of owners – and the overall cost structure? But if local bodies hiked permit fees to cover the cost of the risk, would that feed into increased costs of construction and become a cost of doing business? Again, if they adopted a much more cautious approach to land development approvals, what would be the costs and benefits of that policy change to society.

Recently, we were invited to change our position on local council liability in *Invercargill City Council v Hamlin* [1994] 3 NZLR 513. We refused on the basis that the law reflected current social conditions and

5 The cases are usefully discussed in *Stovin v Wise* [1996] AC 923 (HL). See also *Pyrenees Shire Council v Day* (1998) 192 CLR 330 (HC).

attitudes in New Zealand, a decision that was approved by the Privy Council: [1996] 1 NZLR 513. Further, as I pointed out:

> Changing the basis of risk allocation must have various direct and indirect economic impacts which could only be assessed and weighed in a comprehensive inquiry by those charged with the responsibility. The material before the court is totally inadequate to determine the short run and long-run implications, to quantify the costs involved and to assess the feasibility and desirability of change. Purely intuitive responses are an unacceptable basis for decision-making in this field. (p 528)

However, I cannot help thinking that a enormous amount of litigation and liability costs could have been saved had we been presented with relevant empirical evidence when we first came to decide the question of local council liability.

3.3 Constitutional and administrative law cases

There are some areas in which the use of economic analysis has traditionally been regarded as particularly problematic. Two of these are the areas of constitutional and administrative law (see, for instance, Mason, 1991, p 175 and generally Tribe, 1985). But there is plenty of scope here for issues of a more empirical nature to be raised. For instance, in relation to discretionary remedies in administrative law, the question can be asked what does experience indicate are the likely economic and social effects on the administration of a government department, on the individuals involved, and the ultimate outcome of the particular process challenged in the courts, if decisions of Ministers and officials are quashed? Again, where appeal is by leave only, what are the likely direct and indirect costs and the likely effects on those concerned of granting leave, – including the indirect costs of clogging the court lists? Here I would suggest the law has lagged behind in the limited use made of economic analysis and evidence in the courts.[6]

Consider for example administrative law, which for many years was the jewel in the crown of judicial creativity serving the public interest. Administrative law was largely developed by lawyers who grew up in the 1930s, 1940s and 1950s. It is still redolent of the 1950s. On one view it is a body of public law having as its premise the need to control the exercise of power in a welfare state with a largely regulated economy (see Mason, 1989). But that perception may now may be less accurate in contemporary society where we have experienced a sharp reduction in the degree of

6 These issues are discussed at length in Richardson, 1995.

governmental involvement in the economy – with implications both for the scope of legislative and executive power. The question may now be asked whether there is a continuing public policy reason for treating the role of the courts, in carrying out their judicial review functions, as unaffected by these changes. In some cases, however, efficiency considerations may support judicial review. So, in *Peninsula Watchdog Group (Inc) v Minister of Energy* [1996] 2 NZLR 529 we held that the exercise of discretion under legislation should promote the policy and objectives of the statute. In that case the Minister of Energy had purported to grant an extension of mining licenses outside the 12 month time limit specified in the *Mining Act* 1971 (NZ). We held that there was no public policy reason for treating the circumstances of the case as exceptional, permitting the time limit to be waived:

> It is apparent from this analysis that the legislation is designed to ensure the prompt and programmed consideration and determination of applications for mining privileges. Against that background s 109 reflects the statutory policy that unless special circumstances arise every application for a mining privilege shall be finally disposed of by being granted or refused within 12 months after the date on which the application was made. As Somers J explained in *West Coast Province Federated Farmers of New Zealand (Inc) v Birch and Kanieri Gold Digging Ltd* (Court of Appeal, Wellington, CA 25/82. 16 February 1983) the purpose of s 109 is to prevent land being locked up by an application longer than is necessary to reach a conclusion about it and also to limit the time during which proprietary rights are threatened. (p 534)

Further we were able to point to practices before the legislation which indicated that without the strict time limits imposed under the legislation, advantage was constantly taken of the ease with which adjournments of applications were readily obtainable to lock up for an indefinite period areas of land, water and other subjects of mining privileges. Therefore there was empirical evidence to support the strict approach we adopted to the Minister's discretion.

To turn now to constitutional law, rights jurisprudence puts particular emphasis on individual rights and their protection, although more recently there has been some emphasis, particularly in terms of ethnic consciousness, on group rights, for instance in relation to land, other resources and cultural identity. In this type of analysis relatively little emphasis has been put on community rights. This approach has tended to reduce the scope for recognising competing differential interests in which the government acts so as to benefit some, or a section of the community, or the community as a whole (see further Richardson, 1995).

In *R v Jeffries* [1994] 1 NZLR 290, a case decided under the New Zealand *Bill of Rights Act* 1990, I stated:

> But rights are never absolute. Individual freedoms are necessarily limited by membership of our society. Individuals are not isolates. They flourish in their relationship with others. All rights are constrained by duties to other individuals and to the community. Individual freedom and community responsibility are opposite sides of the same coin, not the antithesis of each other. (pp 302-3)

This is not to say that economic and even empirical analysis may not sometimes be drawn on to support constitutional rights (see, for instance, M Richardson, 1996; Rosenberg, 1997). But I have to say there has been scant reference to economic and empirical considerations in much of the argument that we hear in the constitutional arena, as in other areas of the law. Part of the problem is the cost to the parties of providing the extensive empirical analysis that may be needed to make a full assessment of rights, interests and responsibilities. And courts, under our adversarial system, must – largely, at least – make their judgments on the basis of the evidence before them (see similarly *Dietrich v R* (1992) 109 ALR 385, Mason CJ and McHugh J at 397). It is not a sufficient answer to say that human rights cannot be reduced to a cost benefit analysis. In my view, courts are entitled to be given a very clear analysis of the likely economic and social consequences of the decisions they are asked to make. We have the same information needs in that regard as those involved in law reform and the legislative processes and in executive decision-making.

4. Conclusions

Economic analysis is not an Aladdin's lamp. The chapters in this book show that there is more at stake than market trade-offs. Efficiency concerns are only one factor in an assessment of the public interest. But we need to appreciate the economic costs of less efficient solutions. I have suggested that one of the major challenges facing the courts, the legal profession and the public sector generally is how to obtain and test economic and social data to ensure that existing rules and policy alternatives are assessed in an informed and systematic way. An understanding of law and economics is crucial to this. One of the current problems with the use of economic analysis in court cases is the reluctance up to now of litigants and their advisers to go to the expense and effort of undertaking cost benefit analyses. Litigants are understandably more concerned with resolving their own cases than with providing the court with the means of governing the future behaviour of others. But without

adequate data and the consideration of a range of views there is a risk that an impressionistic economic analysis will add little to existing intuitive assessments of public interest considerations.

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