The dynamic quality of law: The role of judicial incentives and legal human capital in the adaptation of law

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ABSTRACT

In this paper I show that the capacity for a legal regime to generate value-enhancing legal adaptation to local and changing conditions through adjudication depends on its capacity to generate and implement adequate expertise about the environment in which law is applied (*shared legal human capital*). I present a model in which welfare-promoting adaptation of legal rules depends on the incentives of both judges (to risk rule change) and litigants (to bear the cost associated with informing the court about novel features of the environment and alternative rules.) I demonstrate that a legal system will not adapt through adjudication if legal costs relative to damages are either too high or too low, if judicial incentives for change are inadequate or if judicial error rates are initially too high. Comparatively, I show that a legal regime is likely to do better with improved mechanisms for processing information system-wide to reduce judicial error and lower absolute legal costs, but that other apparently beneficial institutional features such as lower relative legal costs, judges who are more willing to adapt law or who make fewer initial errors may or may not lead to lower welfare overall.

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1. Introduction

Positive economic analysis of the evolution of law has, since Posner (1977), been organized around the claim that the value of the common law is its ability to work out, over time, efficient legal rules. Some authors have rested this claim on the premise that common law judges inherently seek efficiency; often this literature has framed the analysis as an investigation of the different incentives influencing parties interacting with courts and legislatures and as a debate about whether judges or legislators are more susceptible to rent-seeking (Posner, 1977; Rubin, 1982; Tullock, 1980). Gennaioli and Shleifer (2007) focus on the impact of judicial bias on the capacity of common law to evolve to efficiency. Other authors have rested predictions about the likelihood that the common law will evolve to efficiency on the incentives of litigants to continue challenging inefficient rules (Rubin, 1977; Priest, 1977; Goodman, 1978; Cooter et al., 1979). Despite differences, these models of the evolution of the common law all share a common recognition that courts do not start out with the right rules. Rather, they move towards them, if at all, only as a product of their interaction with litigants.

With few exceptions (Hadfield, 1992; Talley, 1999; Hylton, 2006), however, the literature on the evolution of common law has not analyzed the process of information acquisition and learning in courts. Similarly, the recent literature comparing the economic effects of common law and civil code regimes has emphasized differences in agency but not learning

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relationships (Glaeser and Shleifer, 2002; Mahoney, 2001). Where information acquisition has been emphasized, it has been in a static rather than dynamic setting. Early work comparing rules and standards (Diver, 1983; Rose, 1988; Kaplow, 1992) and more recent work comparing judicial discretion to rulemaking in legislatures (Shavell, 2007; Anderlini et al., 2008) compares efficiency when a rule is determined in light of ex ante versus ex post information. The strategic revelation literature (Milgrom and Roberts, 1986; Shin, 1994, 1998; Dewatripont and Tirole, 1999; Daughety and Reinganum, 2000) analyzes information acquisition by courts in the context of the efficient application of fixed rules in a static environment.

In this paper I develop a model to explore the dynamic relationship between the institutional attributes of a legal regime and the regime's capacity to learn about and adapt to welfare-relevant changes in the environment. I focus in particular on adaptation through adjudication on the premise that in any legal regime there is welfare-relevant information that is known initially only to those involved in a regulated activity and that rule enforcers (judges) need to know in order to adapt the interpretation and application of legal rules to a changed set of circumstances. The model thus does not evaluate the broader tradeoff between adaptation through a legislature versus adaptation through enforcement institutions such as courts, the question raised by the legal origins literature (La Porta et al., 1997, 1998, 2004; Mahoney, 2001; Djankov et al., 2002, 2003; Botero et al., 2004), which identifies an empirical relationship between economic variables and legal families broadly identified as those rooted in civil law (French, German, Scandinavian) and common law (English). Rather it presumes that some adaptation through courts is both necessary and unavoidable (in any legal regime, including civil code regimes, adaptation comes about not only through overt rule change but also through rule interpretation and judgments about how to apply rules in concrete circumstances) and evaluates the impact of institutional features on the likelihood that welfare-promoting adaptation occurs through this process.

The model focuses on the accumulation of *shared legal human capital* across judges in a legal regime. Shared legal human capital determines the likelihood that judges make mistakes in adapting an existing rule to novel conditions. I demonstrate that the capacity for a legal regime to adapt its legal rules in a welfare-improving direction over time is a function of the interaction of the incentives of judges and litigants.

In particular, I show that for any legal adaptation to occur there must be some judges who face sufficient rewards for rule adaptation to warrant the risk of making errors and litigants must be willing to invest in developing and presenting costly evidence and legal argument in light of the fact that judges make errors in the use of this information. If the risk of judicial error is too high initially, one or both of these conditions may not hold and the legal regime may remain mired at a sub-optimal legal rule with no error-reducing accumulation of legal human capital. More generally, the capacity for legal adaptation through adjudication is shown to depend on five parameters: exogenous legal human capital, system-wide information-processing (which translates individual case information into shared expertise for judges), the distribution of judicial rewards for rule adaptation, the costs of legal processes to judges and litigants and the level of damages. These parameters are determined by the institutional features of a legal regime such as the use of a formally trained career judiciary as opposed to a capstone judiciary, court specialization, publication practices such as the used of signed decisions and the extent and distribution of judicial opinions and the reliance on sequenced hearings as opposed to a single event trial (Hadfield, 2008).

I also compare legal regimes in terms of their capacity for legal adaptation, based on differences in these parameters. I show that lower absolute legal costs and improved information processing unambiguously improve the capacity for a legal regime to adapt its legal rules to changes in the environment through adjudication. Other differences that we might expect to improve legal adaptation – such as more widespread judicial incentives for change or higher initial legal human capital – however, turn out to have ambiguous effects. These apparently salutary attributes can reduce welfare if they cause excessive levels of experimentation with novel rules before enough legal human capital has accumulated to enable judges to implement novel rules (or existing rules in novel ways) with sufficient accuracy.

A further surprising result is that a regime does not necessarily do better if it is better at discouraging opportunistic litigants who seek to induce judges to change rules in welfare-reducing rather than welfare-enhancing directions. This depends on assumptions about the nature of information processing: if increased information across a diversity of cases contributes to the systemic capacity to distinguish when rules should adapt and when they should not, then legal regimes that initially allow in information from opportunistic litigants may reduce judicial error more effectively and benefit more from rule change over time.

The key results thus emphasize that long-run improvements in the capacity for a legal regime to respond to a changing environment require some but not too much experimentation with legal rules to promote judicial learning.

Section 2 lays out the model and then assesses litigants' incentives to invest in the costly effort to educate a court about the new or changed environment and judicial incentives to adapt the rule, given the risk that departing from an established rule will be costly for the judge. This section establishes conditions under which a system will adapt and conditions under which it will remain stuck at an established rule, despite the existence of a welfare-improving adaptation. Section 3 then evaluates the welfare implications of rule adaptation. I show that even if a welfare-improving rule exists, it may not be optimal for a regime to adapt in light of the costs of the proceedings necessary for judges to acquire information and the cost of errors incurred in the process. If sufficient learning benefits accrue, however, it can be optimal for a regime to adapt even when the initial impact of rule adaptation is welfare-reducing. Section 3 compares the level of welfare achieved in regimes that differ in initial legal human capital, legal costs, damages, potential learning benefits and judicial incentives. Section 4 summarizes the results, discusses limitations and extensions and relates this paper to the literatures on