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By Peter Coy

Q: How many Chicago School economists does it take to change a light bulb?

A: None. If the light bulb needed changing, the market would have done it by now.

Chicago-style free-market economics is an easy target for satire, but the movement that flourished at the University of Chicago's economics department in the 1960s, '70s, and '80s really did change the world. Giants such as Milton Friedman, Gary Becker, Robert Lucas, and Eugene Fama provided the intellectual foundation for the political philosophy of President Ronald Reagan and British Prime Minister Margaret Thatcher. In his approach to tax cuts and deregulation, Republican presidential candidate Mitt Romney is an heir to that tradition.

It wasn't just economics that Chicago revolutionized. Across campus at the University of Chicago Law School, scholars such as Ronald Coase, George Stigler, and Richard Posner were inspired to apply economic analysis to laws and regulations, developing a field that came to be called "law and economics." It was law and economics types who promoted the now-conventional idea that the benefits of a regulation must be weighed against its costs. Placing a dollar figure on society's valuation of a human life went from appalling to standard.

They rethought antitrust law, junking simplistic big-is-bad formulations to focus on whether a giant like IBM (IBM) or Microsoft (MSFT) could actually raise prices with impunity. In tort law, they questioned punitive damages that seemed to them motivated by righteous indignation rather than a cool calibration of how to discourage future wrongs. At the apogee of the Reagan-Thatcher era, Chicago Law drew enthusiastic support from businesses and foundations that embraced its small-government message. "Chicago can rightly claim to have been extraordinarily influential in the growth of the field," says Jon Hanson, a Harvard Law School professor and specialist in psychology and law.

Now Chicago's law and economics program is coping with problems born of its success. Its intellectual dominance has triggered a pushback from other social scientists who say it's bloodless—treating people as if they are, or ought to be, perfectly rational calculators of their own self-interest. Even some true believers complain that the field has become too technical. Posner, a federal appellate judge in Chicago, wrote last year in the alumni magazine of the risk that "economic analysis of the law may lose influence by becoming too esoteric, too narrow, too hermetic, too out of touch with the practices and institutions that it studies." Finally, so many other law schools have launched law and economics programs, and so many judges have learned the lingo, that today law and economics "is like the air you breathe. It's just pervasive," says David Weisbach, a Chicago Law professor. That ubiquity has made Chicago less distinctive.

Chicago Law doesn't take such matters lightly. Last October, Dean Michael Schill announced a major initiative to deal with the challenges, to capitalize on the school's place in history, and to keep law and economics relevant for the 21st century. He called it, predictably, Law and Economics 2.0. "Just as Chicago was at the forefront of the first wave of law and economics, so it shall be in the future," he wrote to alumni.

Schill's big idea is to open new frontiers, both intellectual and geographic. This summer the school will play host to 75 Chinese legal scholars, who will get to meet stars like professor emeritus Ronald Coase—still writing in the field at the age of 101. "Coase is a god in China," says Omri Ben-Shahar, who is directing a newly created University of Chicago Institute for Law and Economics.

Meanwhile, Chicago Law professors are lobbing new bombs into the arena—fresh ideas for injecting economic thinking into law and regulation. Chicago Law professor Todd Henderson proposes paying bank examiners in part with "phantom" securities linked to the banking companies they regulate. The phantom bonds, essentially derivatives, would rise and fall in concert with a bank's debt. If banks took too much risk, regulators would feel a hit to their own wealth. To keep regulators from getting so cautious that they ban legitimate transactions, Henderson would throw some phantom stock into their pay packages as well. "There is no reason we can think of why bank regulators should not be paid for performance," he wrote in the spring 2012 issue of *Regulation*, a magazine published by the libertarian Cato Institute.

Chicago Law isn't all about law and economics. President Barack Obama, after all, taught there from 1992 to 2004. So did Supreme Court Justice Antonin Scalia, from 1977 to 1982. (If only they'd overlapped!) Scalia's brand of constitutional "originalism," which deeply respects the intent of the Founding Fathers, is an alien idea to the law and economics crowd, who view law as something more useful than sacred.

Even within law and economics there's ideological diversity. "I don't think it lines up to any political agenda," says Lee Ann Fennell, a specialist in property law. Fennell, daring to challenge a central tenet of law and economics, has written that sometimes property rights can be too strong—say, allowing irrational homeowners to block worthy projects even when accommodating them somehow would be better for all. Her solution: Create an exchange where property owners could surrender certain veto powers over land use for a price before conflicts ever arose. That would help new projects sail through.

Still, there is something to the critique that economics can blind legal scholars to other perspectives. The first generation of law and economics scholars reduced people to stick-figure profit-maximizers who would make rational choices every time. "They came into law schools saying, 'We are social scientists and you are not,'" says Harvard Law's Hanson. Their authority was undermined when a new wave of social scientists, including Daniel Kahneman, Amos Tversky, and Chicago's Richard Thaler, presented evidence that people can be irrational, lack willpower, and have shifting, inconsistent senses of what's in their own best interest.

The human actor in some of the newest law and economics writing is truer to life. Henderson, for example, acknowledges that for some people money isn't the motivation: "Once diligence has been priced, perhaps some regulators will slack," he wrote in *Regulation*.

But Hanson wonders whether law and economics scholars on the whole have gone far enough in incorporating humanity. A case in point: Should the question of motivation matter in assessing damages? A dispassionate law and economics analysis still might say no, while an ordinary juror would say unequivocally yes. As the great jurist Oliver Wendell Holmes Jr. once wrote, "Even a dog distinguishes between being stumbled over and being kicked."

Defenders of Chicago-style law and economics want to be seen not as ideologues, but as realists. Posner again: "We ask not whether the economic approach to law is adequately grounded" in any particular ethical system, "but whether it is the best approach for the contemporary American legal system to follow." That's an appeal to an older Chicago intellectual tradition—pragmatism.