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Introduction

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Modern capitalist societies take two approaches to controlling market failures. One approach relies on relatively specific rules developed and enforced by administrative agencies. In this approach, bureaucrats with technical expertise monitor private parties to ensure compliance. The bureaucrats operate in a larger framework that requires advance notice of and opportunities to comment on any rule changes. In addition, the bureaucrats are subject to political oversight by the executive and/or legislative branches, which limit (for better or worse) the scope of what they can do. This constellation of characteristics defines what is often described as "regulation."

Another approach relies on broad standards that are enforced by courts. In this approach, private parties may contract with one another about their rights and responsibilities; when parties fail to contract, either because their interaction is inadvertent, or because the costs of contracting are too great relative to the benefits, the courts apportion rights and responsibilities between them. The courts are staffed by judges—generalist lawyers who may or may not have expertise in the subject matter underlying the parties' dispute. The judges are sometimes answerable to voters, but often appointed for life and answerable to no one. The courts' decisions are not subject to notice requirements, but can be appealed to another court. This constellation of characteristics defines what is described as "litigation."

The purpose of this volume is to explore the trade-offs between these two approaches. In particular, the chapters will seek to determine the circumstances in which one approach dominates the other; to identify

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general principles that should guide assignment of activities to regulation- versus litigation-based systems of social control; and to investigate which aspects of regulation- and litigation-based systems work well or poorly in practice.

Previous Research on Regulation versus Litigation

The study of regulation and litigation has a long history in law and economics, starting with Ronald Coase's (1960) provocative hypothesis that many types of externalities could be controlled by contract, with the remainder handled by tort law. In Coase's world, informational difficulties and transaction costs are minimal, and disputes (when they arose) would be subject to adjudication by the courts. As Andrei Shleifer points out in his contribution to this volume, this position is consistent with the broader Chicago School suspicion of regulation as an efficient mechanism.

Subsequent work focused on situations that differed from Coase's ideal. This work highlighted the various factors that determined whether regulation or litigation would be preferred from the perspective of social welfare, depending on which of Coase's assumptions failed to hold. Although largely in the theoretical law-and-economics tradition, this growing literature painted a considerably more nuanced picture than did Coase. Isaac Ehrlich and Richard Posner (1974) focused on the trade-offs between rules, which were traditionally enforced through regulation, and (more general) standards, which were traditionally enforced through litigation. Donald Wittman (1977) observed that litigation—which is based on enforcement that takes place after an injury or violation occurs—could be less attractive than regulation when monitoring and assigning responsibility for injuries was more costly than monitoring levels of precaution. Steven Shavell (1984b) proposed a more general framework that balanced the influence of several factors, including informational advantages of a public enforcer, diffuseness of injured parties, limited ability to impose liability on injurers, and high administrative costs of courts.

The liability insurance crises of the 1980s stimulated a wave of empirical research that sought to evaluate regulation versus litigation in the real world. In a comprehensive review of both the theoretical and empirical literature, Don Dewees, David Duff, and Michael Trebilcock (1996) systematically compared the performance of litigation and regulation in terms of the systems' compensation and deterrence goals. Robert Litan and Cliff Winston (1988) examined litigation's deterrent effects in the realms of environmental pollution, occupational accidents, and design and production of defective consumer products. Peter Huber and Robert Litan (1991) reported the results of a series of case studies that compared the performance of regulation and litigation in industries such as aviation, pharmaceuticals, auto manufacturing, and chemicals.

Most (although not all) of these empirical studies questioned the efficacy of litigation. Several cited the unpredictability of the United States' decentralized system of state courts to explain why signals from the tort system often failed to translate into increases in safety. In fact, some claimed that the liability system actually had adverse effects on safety, particularly for long-lived durable goods. Graham (1991), for example, argued that the possibility that courts would interpret design improvements as an admission that a prior design was defective creates a disincentive for safety-enhancing innovation. Others focused on the deadweight burden from the substantial administrative costs imposed by the adversarial nature of the civil justice system. As summarized by Huber and Litan (1991, 15), "the documented direct linkages between liability and safety thus far are weak. In most of the sectors examined, other factors—primarily regulation and bad publicity—seem in the aggregate to provide much more important incentives to providers to improve the safety of products and services."

However, the failures of litigation were most striking in markets for health services. Paul Weiler and coauthors (1993) reported the results of the landmark Harvard Medical Practice Study, which analyzed the medical records of a random sample of 30,000 patients hospitalized in New York in 1984. They found that the sensitivity and specificity of the liability system were quite poor: only one in fifteen patients who suffered an injury due to medical negligence received compensation, and five-sixths of the cases that received compensation showed no evidence of negligence. Daniel Kessler and Mark McClellan (1996) found that these incentives translated into "defensive medicine"—use of precautionary treatments with minimal expected medical benefit out of fear of legal liability. In particular, in a population of elderly Medicare beneficiaries with cardiac illness, they found that direct liability reforms such as caps on damages reduced health spending, but had no effect on patient health outcomes.

The 1990s brought a new phenomenon: the use of litigation to impose regulation. In this scenario, executive-branch agencies or even private parties sue alleged wrongdoers and obtain settlements that govern the defendant's future behavior through a system of highly specific rules. The potential importance of the overlap between regulation and litigation was not a new issue. Although regulatory compliance was not a universal defense to negligence, it was in some cases admissible in tort as evidence. In addition, regulation and litigation were often viewed as substitutes, with optimal regimes containing some of each, depending on the two mechanisms' relative costs (Shavell 1984a).

However, the use of litigation as a means to force companies to accept regulation outside of the normal political process raised several new questions about litigation's dynamic costs and benefits (Viscusi 2002; Moriss, Yandle, and Dorchak 2009). On one hand, to the extent that litigation-inspired regulation addressed risks that, because of political market failures, were unacknowledged, then it might improve welfare. On the other hand, to the extent that litigation-inspired regulation allowed attorneys general to usurp the authority of the legislature, or allowed the plaintiffs' bar to extort funds from business to be shared with government officials, then it might reduce welfare.

The Current Volume

The current volume is a collection of eleven chapters, three of which are theoretical and eight of which are empirical. Although the three theoretical chapters offer distinct perspectives on how the trade-offs between regulation and litigation should be understood, they share some common themes. They agree in broad terms on the sorts of characteristics that determine whether a system should be viewed as regulation- or litigation-based. In addition, they agree that the two methods of social control are best viewed as the extremes of a continuum.

The taxonomy that Richard Posner proposes in his contribution makes this point clear. According to him, a regime can be characterized in four dimensions: the extent to which it relies on ex ante versus ex post metrics; on rules versus standards; on experts versus generalists for design and implementation; and on public versus private means of enforcement. In practice, every regime will be somewhere in the middle on each dimension. Litigation-based systems often have regulatory qualities, and vice versa; regulatory agencies often have provisions for court-like hearings when the agency's interpretation of rule is disputed; and courts bind themselves with rules, such as the judge-made rule entitling criminal suspects to a probable cause hearing within forty-eight hours of arrest.

Andrei Shleifer argues that Posner's four dimensions can be collapsed into one: the extent to which courts function well or poorly. By putting the focus on courts, Shleifer's chapter is very much part of the Coasean tradition, while at the same time highly critical of its sometimes unrealistic assumptions. He makes the point that regulation is ubiquitous in modern societies because courts fail. His analysis, however, extends beyond the usual enumeration of the magnitudes of the burdens imposed by transaction costs and imperfect information. He also proposes a political economy model that links the rise of the regulatory state to income inequality—and explains how this rise may be efficient. When enforcement is mostly private, the side with greater resources is likely to have a substantial advantage in court. This advantage may not only exacerbate the preexisting inequality, but also lead to a biased standard of care that reduces (distribution-neutral) social welfare.

Fredrick Schauer and Richard Zeckhauser explore a specific failure of litigation: its dependence on particular cases. They argue that making policy on the basis of cases is problematic because aberrational, rather than representative, cases tend to be the subject of lawsuits. The fact that litigated cases are nonrepresentative is well known (e.g., Priest and Klein 1984). However, as Schauer and Zeckhauser point out, failures of rationality (or, in Coasean terms, costs of information) may nonetheless preclude parties from correctly translating nonrepresentative case outcomes into decision rules to govern behavior in ordinary situations. More importantly, the cognitive availability of unrepresentative cases may lead judges to focus on the wrong issues; rules will be made to deal with the wrong events in the world. And although this is a particular problem with litigation, they observe as well that many legislatively or administratively created rules and regulations, such as Megan's Law and the Brady Bill, are also spurred by unusual cases, and thus often suffer from their case-inspired origins.

The eight empirical chapters include case studies in public health, financial markets, medical care, and workplace safety. However, these chapters have broader implications beyond the particular cases they examine.

The two chapters in public health deal with tobacco and guns. Joni Hersch and W. Kip Viscusi provide an assessment of the consequences of the tobacco Master Settlement Agreement (MSA), which took effect a bit over a decade ago. State attorneys general and tobacco companies entered into the MSA to resolve a series of lawsuits in which the states sought to recoup their cigarette-related Medicaid costs. The MSA imposed numerous regulatory requirements as well as financial payments from the cigarette manufacturers to the states. Unlike damages payments in most tort cases, the MSA payments were based on future sales, not past behavior; this had the effect of making the payments economically equivalent to an excise tax, and shifting their burden from tobacco-company shareholders to future smokers. This payment structure had the ironic effect of increasing states' dependence on future tobacco sales for their revenues, even as they had sued cigarette manufacturers over the dangers of smoking.

The tax and regulatory components of the MSA also may have potential anticompetitive effects. The MSA's restrictions on cigarette advertising have led to a plummeting of advertising expenditures, which may impede new entry into the market and the introduction of new products. Likewise, there may be anticompetitive effects arising from the requirement that new entrants are subject to the MSA payments despite having no past wrongful conduct. Potential new entrants were not represented in the negotiations that led to the MSA. Although Viscusi has written extensively on political and economic consequences of the MSA, his contribution with Hersch is more comprehensive in scope and provides the most up-to-date examination of the agreement that exists, including an analysis of the recently-passed Family Smoking Prevention and Tobacco Control Act.

Philip Cook, Jens Ludwig, and Adam Samaha evaluate the likely effects of the U.S. Supreme Court's decision in *D.C. v. Heller,* 118 S. Ct. 2783 (2008). In that decision, the Court struck down the District of Columbia's handgun ban, recognizing for the first time an individual constitutional right to own a gun. While the immediate effect of the opinion is to invalidate an unusually stringent regulation in a city that is also an enclave of the federal government, the reach of the decision is not yet clearly defined. Cook, Ludwig, and Samaha predict that the decision will ultimately increase the prevalence of handguns in jurisdictions that currently have restrictive laws, and as a result, increase the burden of crime due to more lethal violence and more burglaries. They note, however, that if the ruling is understood as providing people an entitlement to own handguns for self-defense, then from that starting point it is plausible that the "ban on bans" is justified, but so are reasonable restrictions that raise the price of handguns.

These two chapters are both about "regulation through litigation." The MSA imposed regulation through litigation; the Heller decision limited it. Both chapters are also critical of the phenomenon, primarily on grounds that judicial intervention in matters that have been traditionally the province of the legislature constitutes an end-run around the political process. However, as both chapters acknowledge, evaluating such end-runs in general is difficult. To do so would require a political economy model that considered the extent to (and circumstances under) which the judiciary should be allowed more or less latitude to limit regulation than to impose it; this is an important topic for future research.

The contributions of Tomas Philipson, Eric Sun, and Dana Goldman and of Adam Gailey and Seth Seabury address another general issue in the study of regulation versus litigation: whether duplicative control by regulation and litigation leads to advantages over and above those that could be obtained with either system alone.

Philipson, Goldman, and Sun conclude that the answer to this question in the realm of prescription drug safety is no. In the United States, drug safety is governed jointly by the Food and Drug Administration, which oversees premarket clinical trials, and the liability system, which allows patients to sue manufacturers for injuries. They examine the adoption of the National Vaccine Injury Compensation Program, which sharply reduced vaccine manufacturers' liability in 1988. They find that the Program reduced vaccine prices without affecting vaccine safety, consistent with the hypothesis that duplicative control by regulation and litigation is inefficient.

Gailey and Seabury conclude that the answer to this question in the realm of workplace safety is yes. They examine how workers' compensation rules affect the impact of employment protection statutes on the labor market outcomes of the disabled. They estimate whether statutorily-required "reasonable accommodation" of workers' disabilities reduces the workers' compensation costs of workers who become disabled due to a workplace injury. Put another way, they test whether the costs of the litigation-based system of protection from workplace discrimination might be at least partially offset by savings in the regulation-based workers' compensation system.

Based on their analysis of March Current Population Surveys from 1996 to 2007, they find that the interaction between workplace discrimination law and workers' compensation leads to lower costs than would be expected from the two mechanisms considered independently. Changes to the California Fair Employment and Housing Act that required greater accommodations of workers' disabilities led to increased rates of employment for workers' compensation recipients as compared to other disabled workers.

Alison Morantz examines the performance of the workers' compensation system more generally. Her chapter shows how a regulatory system can become more litigious than the litigation system itself. The "great compromise" of worker's compensation, whereby workers relinquished the right to use their employers for negligence in exchange for no-fault compensation for occupational injuries, was one of the great triumphs of regulation over litigation in the twentieth century. As Morantz observes, with the joint support of workers and employers, every state adopted a workers' compensation law between 1910 and 1948. Today, participation in the workers' compensation system is required in most states.

Yet in recent years, the workers' compensation system has been criticized for becoming increasingly like the litigation system it was originally intended to replace. In response, some large employers in the state of Texas—the only state that has preserved an elective statutory scheme—have begun opting out of the workers' compensation system and permitting their employees to sue them for workplace injuries in tort.

Based on a unique survey of large, multistate "nonsubscribers" to Texas workers' compensation, Morantz documents the remarkable turnabout in the system's appeal to large firms since its inception almost 100 years ago. Although workers' compensation may have once offered the advantages of regulation, from the perspective of most surveyed corporations, it now suffers from many of the shortcomings of litigation. According to Morantz, Texas nonsubscribers reported that opting into the tort system *reduced* costs, litigation, delays in claim reporting, and delays in employees' return to work relative to workers' compensation. She also reports several additional interesting findings. Virtually all surveyed nonsubscribers compensated injured employees, regardless of fault, for occupational injuries. Unlike workers' compensation, however, most of these "home-grown" occupational-injury plans did not impose any maximum weekly dollar amount or waiting period on the receipt of wage replacement benefits. On the other hand, such plans typically imposed stricter reporting guidelines, capped total benefits, allowed the employer to direct medical treatment, and excluded payouts for permanently-disabling injuries. Most surveyed firms also sought to limit their tort exposure by resolving disputes through mandatory arbitration.

The contributions of John Coates, Stephen Parente, and Tom Chang and Mireille Jacobson investigate the relative advantages of regulation and litigation in settings that have been previously unexamined. John Coates compares the law governing mergers and acquisitions (M&A) in the United States and the United Kingdom. One dimension of M&A law is the treatment of "break fees"—payments that the target of a merger offer agrees to make to a prospective acquirer in the event the target is ultimately acquired by someone else. Break fees have two competing effects on shareholders' interests: although they may encourage prospective bidders to participate in an auction, they may also enable managers to favor bidders who will enrich the managers at shareholders' expense. Break fees are routinely restricted as part of the corporate law doctrines of the United States and the United Kingdom. In the United States, courts review break fees in ex post litigation, applying a general common-law standard of fiduciary duty; the United Kingdom caps such fees with a bright-line rule set by a regulatory body.

Based on his analysis of 2,579 bids for U.S. and UK corporations from 1989 to 2008, Coates finds that the break fees are statistically significantly lower in the United Kingdom than in the United States. In addition, he finds that the number of deals with competing bids is higher in the United Kingdom, and the number of completed bids is lower. Although he cautions against drawing any welfare conclusions, his results suggest that a regulatory approach to M&A has at least some gross (if not necessarily net) social benefits, in the form of stronger competition for targets conditional on an M&A bid, but may come at the cost of reduced M&A activity.

Steve Parente evaluates the performance of a new regulatory mechanism to detect prescription drug misuse. As he and many others have pointed out, prescription drug misuse generates large negative externalities. Most efforts at controlling misuse, however, are based on ex post approaches implemented by generalized law enforcement agencies. Parente proposes a medical-claims-based algorithm that compares a prospective drug purchaser's observable characteristics to those that have been historically associated with misuse. He finds that several commonly-observable characteristics are significant predictors of misuse. He concludes with a discussion of how point-of-service fraud detection and intervention systems used by banks and credit card vendors could be adapted to this setting.

Tom Chang and Mireille Jacobson examine the use of a cap-and-trade mechanism to regulate hospitals' provision of essential services. They study California's mandate that all general acute care hospitals retrofit or rebuild in order to maintain their structural soundness after an earthquake. They demonstrate that the mandate has important unintended consequences for the availability of hospital services and the provision of charity care. They propose an alternative regulatory mechanism: a system in which each California hospital would be required to provide a given number of earthquake-safe beds, but then be allowed to pay a neighboring hospital to satisfy their requirement. They show that this cap-and-trade system could achieve the goal of insuring a minimum number of operational hospital beds after an earthquake at a much lower cost than the existing mandate.

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