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An Overview of Economics and Regulation

## 1. Introduction

An important connection exists between economic research and regulation, in particular in fields of the law important to the economy, such as regulation of companies, taxation and contractual relations. This has been recognised and elaborated by the law and economics movement. The connection is, however, not entirely straightforward, regardless of whether it is seen from an economic or a legal perspective. Problems concern such things as how economic research might be applied in a regulatory context and in law finding or what legal knowledge is necessary for robust economic research on the impact of regulation.

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In this conference paper our aim is to discuss problems concerning the connection between economics and regulation, and how they can be handled, briefly. As a stepping stone we address some principal questions of how economic research might be applied. Thereafter we turn to regulatory methods and models, in part directing the discussion to regulation as such, in part to regulatory techniques, and how they influence law finding. We conclude with a brief discussion on problems which might be associated with application of economic research in a regulatory context.

## **2. Economic theory, empirical research and regulation**

For long legal scholars have appreciated the economics might affect law and that it often is desirable with insights in economics for regulators. As early as 1843 it is stated in the Swedish legal periodical *Juridiskt Arkiv* ('Legal Archives'):

'Before we turn to a closer examination of the concepts and contents of economic law, we would like to draw attention to, that political economics as the basis for all economic law must be studied.'<sup>1</sup>

During the last decades the literature of different schools of law and economics has literally exploded. The impact of law and economics research has also given rise to a both scholarly and practical discussion of problems of regulation influenced by economic research. This discussion is in part of great methodological value, in part misinformed. It could, even if that might be over the top, be put that while it seemed to have been natural for lawyers in the 19<sup>th</sup> and early 20<sup>th</sup> century to take economic research into account, this is today more controversial. The legal scepticism should probably be referred to both a lack of tradition and a lack of methods to evaluate the ever-increasing research in economics. It might also reflect that economics is but one tool among several which might be prayed in aid then regulating.

Now, how could economic research be of use in the regulatory process?<sup>2</sup> Although this obviously might differ depending on the societal, economic, and political context, some general observations might be fruitful. Generally it would not be considered controversial to use economic empirical research or economic theory descriptively; that is to describe potential effects of regulation. It might be added

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<sup>1</sup>Schmidts *Juridiskt Arkiv* 1831, 99 at p. 137 et seq.

<sup>2</sup>Cf. Stattin, *Företagsstyrning. En studie av aktiebolagsrättens regler om ägar- och koncernstyrning*, 2 ed., Uppsala, 2008, chapter 2.

that, in fact, it could be more accepted to use theory as opposed to empirical results as long as empirical research is not conclusive. If this approach is criticised it probably would depend on for instance how the research have been carried out, whether it is robust or whether its methodology is open to critique.

A well known and often cited example of economic research which have both contributed to the understanding of the economic impact of law and can be criticised from a legal point of view, is the research in ‘law and finance’ carried out by American economist and Nobel Foundation Professor La Porta and his associates.<sup>1</sup> This law and finance approach can be characterised as ‘jurimetric’ in as much as it calculate the function of law — for instance the level of shareholder protection — by reference to numeric criteria. While the law and finance research has contributed to the understanding of law and finance, it is easy to question, for instance due to:

*The perception of comparative law.* The Law and finance approach often has a focus on rules whereas comparative law focuses on the function of law.

*Focus on legal systems.* It is highly doubtful whether it is at all fruitful to focus on the origin of legal systems as law always have been influenced by different jurisdictions.

*Choice of criteria.* If certain legal rules are compared, it is easy to miss other rules that might affect the results.

*Number of criteria.* Few criteria make the results blunter, whereas too many criteria might make it to complex.

*Level of complexity.* In most jurimetric research the results are measured at a given time and on a short scale, such as none or one point. For a more true result the legal development should be measured and a more diverse scale should be applied.

*Lack of contextual understanding.* The impact of legal culture is often missing.

*Bias.* It seems that jurimetric research often is biased towards the jurisdiction of the researcher.

What has been said is not an attempt to reduce the value of La Porta’s research specifically, or law and finance research generally; rather our intention is to illustrate that interdisciplinary research is difficult and requires careful thought when it comes to methodology.

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<sup>1</sup>La Porta, López-de-Silanes, Shleifer and Vishny), *Law and Finance, Journal of Political Economy*, December 1998. Reprinted in J. Schwalbach ed., *Corporate Governance; Essays in Honor of Horst Albach*, Publications of the Society for Economics and Management at Humboldt-University Berlin, Berlin, Springer, 2001.

Close to, but not the same as, descriptive application of economic theory or empirical research is normative use of economics, namely use of economic research results in a legal-political argument *de legeferenda* (on what the law ought to be). Generally, this is accepted. It should be noted, however, that economic research results are not the only reasons to regulate that is valid in a legal-political context.

It is more doubtful whether economic theory or empirical research might be of use in deciding singular cases or controversies, for instance in the courts, in order to motivate construction or application of valid law — firstly methodological problems exist, secondly it is difficult within an economic model to pay due consideration to the particularities of singular cases. This goes back to the fundamental differences between law and economics as scholarly disciplines. While the law is aimed at providing methods to solve singular cases, economics has a structural approach to research. It is only natural that it is less fruitful to try to apply a structural approach when deciding singular cases.<sup>1</sup>

### 3. Regulatory perspectives

It is now time to say something on regulatory perspectives, in other words how regulatory activities should be perceived. Two variants of regulatory perspectives should be considered: the regulation of particular issues on the basis of economic theory or empirical research, and the regulation of a whole field of law in order to achieve (among other things) economic aims.

An example of the former is the regulation of corporate representation in article 9 of the first European company law directive. The directive does not have a thought through approach to economic problems that might arise when its rules are applied. However, the rules on corporate representation have. In the *travauxperparataire* it seems clear that the said rules are aimed at abolishing the ultra vires doctrine, which worked to the detriment of both companies and their contractual parties, thus minimising transaction costs and increasing efficiency.

An example of the later is the companies legislation in for instance the United Kingdom or most Scandinavian countries. The UK Department of Trade and Industry stated the aims of the reform leading to the UK Companies Act of 2006 as follows:

‘[support] the creation, growth and competitiveness of British companies and partnerships,

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<sup>1</sup>Cf Cheffins *infra*.

[promote] an internationally competitive framework for business, so that UK continues to be an attractive place to do business,

[provide] straightforward, cost-effective and fair regulation which balances the interest of business with those of shareholders, creditors and others,

[promote] consistency, predictability and transparency and underpins high standards of company behaviour and corporate governance.’<sup>1</sup>

The legislative intent behind the UK Company Law Reform is expressed in economic terms. The economic nature of the legislative intent opens the law to economic arguments, both in the regulatory process and in construction of the rules after their promulgation. Professor Brian Cheffins, Cambridge University, puts it

‘Since conventional legal discourse is unlikely to be adequate, academics seeking to evaluate the DTI’s current efforts at reform should make explicit use of theory. By taking into account how business enterprises operate and by assessing the impact which legal rules are having on existing patterns of behaviour, it should be possible to gain a sense of whether a legislative regime is placing undue restrictions on beneficial corporate activity or is exposing various constituencies affiliated with companies to excessive risks. As we have seen, interdisciplinary methodology can be used to gain a sense of how legal rules affect corporate activity.’ Theoretical analysis therefore should provide academics with the means required to evaluate current and proposed legislation in accordance with the terms set down in the DTI’s 1998 discussion paper.’<sup>2</sup>

Professor Cheffins is concerned with academic evaluation of law. We submit that the same applies to those who try to find the law in a singular case, as long as economic thought is akin to the legislative intent.

#### **4. Economic models and regulatory models**

So far it we have shown that it is relatively accepted to let economic theory or empirical research influence regulation. We will now turn to how this might be achieved in practice.

Most common, but probably least useful, is what can be characterised as spontaneous economic reasoning in the regulatory process — the discussion of effects of regulation present in

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<sup>1</sup>DTI directive, *Company Law Reform*, pp. 6 och 14.

<sup>2</sup>Cheffins, *Using Theory to study Law: A Company Law Perspective*, 58 CLJ 197 (1999) at p. 218.

*travaux préparatoires* of European Union legislative acts is often of this character: from more or less empirically decided starting points, how the proposed regulation might affect the economy, small businesses, or something else is discussed. Even if it might be fruitful to discuss the effects of regulation in economic terms, such a discussion of a slightly more ambitious — for instance using scientific methods — nature would sometimes be even more useful.

A second way to use economics is to apply more or less explicit law and economics methods. Most well known are probably classical law and economics approaches, such as elaborated by the so called Chicago school of law and economics with prominent members such as professor and judge Richard Posner.<sup>1</sup> Classical law and economics is sometimes complimented or substituted with theory from other economic or social science research fields, for instance a growing literature in behavioural law and economics<sup>2</sup> have influenced at least the academic debate on regulation. Behavioural law and economics need not be looked upon as an alternative to classical law and economics, but as a further approach to evaluating the regulation. Typically, it would more easily for regulators, or lawyers in general, to appreciate behavioural law and economics as this school of economic thought are more akin to traditional legal thought on the regulation as offering remedies or providing rules on a case by case basis.

In this context it might be useful to point out that it is one thing to make theoretically coherent arguments on how regulation ought to be shaped, and a totally different thing to really show that economic effects occur. To draw empirical conclusions from economic facts is however not a task suitable for lawyers, as they are not trained in empirical research.

From this two conclusions can be drawn: Firstly that regulation in most cases, at least when it deals with economic conditions, will have a higher quality when lawyers and economists cooperate. Secondly as it is difficult to draw conclusions from empirical research and different researchers often end up with different results, regulators will more often than not lack conclusive evidence on economic effects. Lack of empirical results should however not entail that economic research is not considered in a regulatory process — still economic theory might be of use in evaluating probable effects of

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<sup>1</sup> Most well known work is *An Economic Analysis of Law*, 7 ed. 2007.

<sup>2</sup> Cf. Sunstein, *Law and Economics: A Progress Report*, American Law and Economics Review, Vol. 1, No. 1, pp. 115-157, 1999.

regulation. Especially if economic theory coincides with practical experience, it is a strong argument for what the law ought to be. An example of this might be incentives to corporate managers which have proven extremely difficult to justify empirically, but seems to work from both a theoretical and a practical perspective.

A closely connected question is whether economic theory can shed any light on what regulatory models should be applied.<sup>1</sup> In general three variants of regulatory models are used, often within the same legislation, namely mandatory rules, opt out rules and opt in rules. From economic theory it might be concluded that, simply put, mandatory rules should apply when those protected by the legislation does not have a legal *locus standi*, or in other words a real possibility to influence the outcome of negotiations or decision-making. A typical example would be creditor protection rules in company law. Opt out and opt in rules should apply within the meaning of the standard contractual effect of legislation, for instance when the legislation provides solutions from which the parties to a transaction may deviate. A typical example is company law rules aimed at protecting shareholders, which in most legal systems might be broken with the consent of wronged shareholders — such rules, for instance requirements to have a statutory audit in UK law, might instead be negotiated away by the shareholders if they do not see the need for such rules. By negotiate away certain rules which have been provided in the legislation (as a standard contract) the shareholders are using an opportunity to opt out. If, instead, the shareholders create new rules in the articles of associations they are opting in such rules.

A combination of mandatory rules, optout rules and opt in rules have been utilised in the UK Companies Act 2006, thereby creating a flexible regulation for British companies. As the law provides rules that most shareholders and other parties would demand with an optout possibility and rules that will not be of need often with an opt in possibility, the transaction costs for drafting rules or trying to circumvent the law should be significantly lower.

## **5. Brief concluding remarks**

To very briefly conclude: We could summarise the contents of this essay with stating that economic theory and empirical research is a valuable tool in regulation. It might be difficult to apply or to comprehend the implications of economic research in a regulatory

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<sup>1</sup> This is discussed in an European (mostly British) context by Cheffins in *Company Law: Theory, Structure and Operation*, 1997.

context, but it would at least be fruitful in the long run to develop coherent methods to do this.

DTI directive, *Company Law Reform*.

Cheffins in *Company Law: Theory, Structure and Operation*, 1997.

Cheffins, *Using Theory to study Law: A Company Law Perspective*, 58 CLJ 197 (1999).

La Porta, López-de-Silanes, Shleifer and Vishny), *Law and Finance, Journal of Political Economy*, December 1998. Reprinted in J. Schwalbach ed., *Corporate Governance; Essays in Honor of Horst Albach*, Publications of the Society for Economics and Management at Humboldt-University Berlin, Berlin, Springer, 2001.

Posner, *An Economic Analysis of Law*, 7 ed., 2007.

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Stattin, *Företagsstyrning. En studie av aktiebolagsrättens regler om ägar- och koncernstyrning*, 2 ed., Uppsala, 2008.

Stunstein, *Law and Economics: A Progress Report*, *American Law and Economics Review*, Vol. 1, No. 1, pp. 115-157, 1999.

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## **О МЕТОДОЛОГИИ В ПОЛИТИЧЕСКОЙ ЭКОНОМИИ И ЭКОНОМИЧЕСКОМ АНАЛИЗЕ**

**АННОТАЦИЯ.** В статье рассматриваются проблемы взаимосвязи методологии в политической экономии и экономическом анализе. Аргументируется, что основная посылка современного экономического анализа о нейтральности «технических» приемов исследования, вытекает на самом деле из той или иной философско-методологической позиции автора. Обращается внимание на особенности политико-экономического анализа в отечественной народнической школе, которая не отрицала связи экономической науки с политикой и идеологией.

**КЛЮЧЕВЫЕ СЛОВА:** политическая экономия, методология, история экономического анализа, народническая экономическая мысль

**АНОТАЦІЯ.** В статті розглядаються проблеми взаємозв'язку методології в політичній економії і економічному аналізі. Аргументу-