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**Harmonising Hayek and Posner:
revisiting Posner, Hayek the economic
analysis of Law**

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ABSTRACT

This paper is aimed at highlighting Posner and Hayek's consensus on the importance of decentralization, as well as the significance of the incorporation of non-legal actors as tools for facilitating the efficient allocation of resources in common law. In addition to highlighting the consensus on the views of Posner and Hayek, in respect of de centralization of information within the judicial process, this paper aims to address why de centralization serves as a vital tool in facilitating the objective of common law as an efficiency allocation mechanism. Whilst it is argued that lower court judges may not and should not be given such flexibility to make and unmake the law, the principles and decisions of law lords acting in the capacity of legislature, have also illustrated in several leading cases that the flexibility intended by Parliament may be misinterpreted and wrongly applied in future cases. This has also resulted in the criticism of extrinsic aids to statutory interpretation. This paper analyses and expands on these observations.

Key words: legitimate expectations, certainty, flexibility, judicial precedents, statutory interpretation, allocative efficiency, *Pepper v Hart*, *Daubert*, common law, regulatory capture, regulation

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Harmonising Hayek and Posner: Revisiting Posner, Hayek & the Economic Analysis of Law

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A Introduction

I To Be or Not to Be Regulated: Purposive Rules and the Centralisation of Information

The de-centralisation of the judicial and legislative process has advanced over the years – as evidenced by the engagement of legal, non-legal and economic actors in the judicial and rule making process. This serves as testimony to the fact that judges may not be fully equipped to allocate information in such a way that maximal efficiency or the best outcome is derived for involved parties. Other non-legal actors such as financial experts are now being engaged as expert witnesses in deciding landmark judgments.

As well as a tool which serves to facilitate greater checks and accountability in the judicial and law making process, de centralization is also accentuating its role as a mechanism whereby the efficient allocation of information can be realized. In addition to highlighting the consensus on the views of Posner and Hayek, in respect of de centralization of information within the judicial process, this paper aims to address why de centralization serves as a vital tool in facilitating the objective of common law as an efficiency allocation mechanism.

According to Cooter and Rubinfeld,² fair and accurate outcomes requires courts to resolve cases by applying the law and courts have complete information when full knowledge of the law and all the facts that are relevant to the case, are available and are at disposal to deciding matters at hand. Further they are of the opinion that complete information at trial results in a judgment that is accurate relative to existing law; and that to the extent that liability law is designed to internalize costs, accurate results will generate efficient incentives. In the same manner, they further argue,

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² R D. Cooter and D. L. Rubinfeld “An Economic Analysis of Legal Discovery” at page 437

that complete information in bargaining before trial promotes settlement on terms approximating the complete information judgment.

The importance of measures aimed at ensuring that the court receives complete information, prior to the case or trial – as a means of generating efficient outcomes in the delivery of judgments, is hereby emphasized. However current issues revolving around procedures aimed at obtaining complete information is also highlighted. Such problems in their opinion, could be mitigated where the court is able to ascertain the value of information to the requesting party – hence ensuring that such a party fully pays the associated costs of complying with rules.³

The importance of ascertaining the stakes involved for the involved parties is not only vital from the perspective of delivering efficient outcomes – which would re inforce the role of common law as a tool for promoting the efficient allocation of resources, but also highlight why the determination of such stakes constitutes an influential factor in the evolution of common law. section II of the Literature Review further corroborates and consolidates on this point.

The third section then consolidates on the de centralization of information retained by judges in the judicial process by way of reference to Posner’s views on Hayek and Kelsen’s concepts of law. In arriving at a conclusion that many factors determine and have influenced the evolution of common law over the years, the concluding section also highlights why it is necessary to engage non legal actors in the judicial process.

II Posner’s conception of law as “a series of disparate rules, and as purposive”⁴

The development of judicial precedents and the role of judges in the interpretation of statutes and legislation - to better align with the original intent of the legislator, has been evidenced over the past centuries. Certain cases, however, have reflected possibilities whereby judicial development may generate outcomes which are contrary to legislative intent. This can be illustrated by section10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, which has been highlighted as having been interpreted “to require corporate insiders and tippees to either disclose material inside information or refrain from trading.”⁵

Carlton and Fischel argue that such judicial development is contrary to legislative intent and that no evidence exists to support the fact that Congress intended to prohibit insider trading.⁶

³ See *ibid*

⁴ TJ Zywicki and ABSanders, “Posner, Hayek & the Economic Analysis of Law” Iowa Law Review Volume 93 No 2, pp 559-603 February 2008, George Mason University Law and Economics Research Paper Series, see particularly abstract

⁵ SEC v Texas Gulf Sulphur Co, 401 F.2d 833 (2d Cir 1968) (en banc), cert denied, 404 U.S. 1005 (1971). See D Carlton and D Fischel, “The Regulation of Insider Trading” Stanford Law Review Volume 35 No 5 (May 1983) pp 857-895 at page 884

⁶ see *ibid*

Further, whereas Hayek is considered to view the common law as a “spontaneous order which regulates society better than a person could”⁷, Posner is considered to view the law as “an order consciously made through the efforts of judges and legislators.”⁸

However Posner’s conception of the law as an “an order consciously made through the efforts of judges and legislators,” appears to exclude his acknowledgement of the engagement of non-legal actors as instruments or means of attaining legal goals. This will be discussed in greater detail under section C of this paper.

Such above differing views about levels of control of the law and perceptions of being regulated and the ability to regulate, can be regarded as influential factors governing the opinions also shared by Posner and Hayek on the roles of judges – one which Posner considers to be more active than passive. The question revolving around why firms might want to allocate “property rights in valuable information”⁹ to managers, rather than to shareholders, is not merely based on the premises that managers may value such information more than shareholders, but also attributed to the ability of such agents to better monitor, supervise and account for the distribution and dissipation of such information in a manner and timing (which shareholders are less better equipped and specialised to handle).

From this perspective, it could be argued that whilst information regulates those who are less specialized and equipped to handle such information, the delegation and centralization of such information to those who are better specialised and equipped to handle such priceless resources and privileged public utilities, generates an outcome whereby such information is better regulated, as well as maximised.

In like manner, whilst law, and in particular the common law, could regulate those who are less specialised to handle such rules, they are regulated by more capable individuals and authorities. Hence the question does not necessarily and merely relate to whether law is being regulated or regulates, but rather, why it should be regulated and the agents through which such regulation should take place.

In their article, Carlton and Fischel, also argue that “even if Federal regulation is justified on the basis of law enforcement cost, firms should have the opportunity to opt out of the regulation in the

⁷ F.A. Hayek (1960). *The Constitution of Liberty*. Chicago: University of Chicago Press and F.A. Hayek (1973). *Law, Legislation and Liberty: Rules and Order*, Volume 1. Chicago: University of Chicago Press.

⁸ See R. A. Posner, (2005) "Hayek, Law, and Cognition," 1 *New York University Journal of Law and Liberty* 147

Also see TJ Zywicki and AB Sanders, “Posner, Hayek & the Economic Analysis of Law” *Iowa Law Review* Volume 93 No 2, pp 559-603 February 2008, George Mason University Law and Economics Research Paper Series, see particularly abstract

⁹ See D Carlton and D Fischel, “The Regulation of Insider Trading” *Stanford Law Review* Volume 35 No 5 (May 1983 at page 866

absence of any showing of third party effects, and that such firms are best judges of how to structure the terms of their employment contracts.”¹⁰

Therein lies the argument for enforced self-regulation. Whilst individual firms may be the best judges to decide on the design of their contracts, in order for those contracts to be tailor made to adjust better to their firm’s needs, self-regulation through these firms, maybe better enforced by the State and through the courts. Even with its advantages, certain disadvantages can also be attributed to self-regulation.¹¹ As well as being consequential of a lack of transparency in a regulatory and supervisory regime, regulatory capture is also more likely to occur where a system of self-regulation operates.

The aim of the ensuing section is to highlight the importance of the purposive application of rules in the “updating” process. Such a goal will be facilitated by way of reference to the rules of statutory interpretation. The section also aims to highlight why the engagement of non-legal actors in the judicial process serves as a tool for bolstering claims relating to the efficiency of common law as a resource allocation mechanism.

¹⁰ see *ibid* at page 895

¹¹ For further information on the advantages and disadvantages of Self-Regulation, Enforced Self-Regulation see M Ojo, “Co-operative and Competitive Enforced Self-Regulation: The Role of Governments, Private Actors and Banks in Corporate Responsibility http://mpr.a.ub.uni-muenchen.de/27850/1/MPRA_paper_27850.pdf; also see I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* Oxford University Press at page 102

B Literature Review: The Evolution of Common Law

The Evolution of Common Law: Rules of Statutory Interpretation

The purposive intent of rules and the legislator constitutes a fundamental characteristic of the common law system. In illustrating the increased role of judges, by not only adhering to the legislator or legislation, and the growing importance of interpreting rules with intent, the application of rules of statutory interpretation and the evolution of such rules will be elaborated on:

The Literal Rule of Statutory Interpretation

This usually constitutes the basic, starting point in construing a piece of legislation. Under this rule, judges are required to interpret statutes and legislation according to their ordinary, natural and dictionary meaning even if the outcome of such an interpretation may generate absurd or ridiculous results. Judges' roles are considerably limited and restricted under this rule and may be regarded as being more passive when compared to their roles under the other methods of statutory interpretation. Whilst certainty appears to be an advantage of complying with this rule, such advantageous attributes must be weighed against the results which are obtained where absurd outcomes are generated and the legitimate expectations of parties involved are effectively not met.

For this purpose, the golden rule constitutes the next resort where absurd results need to be mitigated.

The Golden Rule of Statutory Interpretation

Under this rule, judges are not only required to give effect to the literal meaning and application of the rule, but should also do so with the aim and purpose of avoiding an absurd result. The golden rule is namely, thus:

“The golden rule is that the words of a statute must *prima facie* be given their ordinary meaning.”

- Viscount Simon (Nokes v Doncaster Amalgamated Collieries)¹²

¹² [1940] A.C 1014 at page 1022

The Mischief Rule of Statutory Interpretation

The mischief rule represents a much narrower application of the golden rule - narrower in the sense of its greater focus on the intent of the legislator. Its application is considered necessary where a statute is considered to have been introduced as a means of remedying or rectifying a defect or problem (the mischief) in the common law.

An extension of the application of the mischief rule is embodied in the fourth and final rule of statutory interpretation being considered under this heading: namely, the purposive rule or the Rule in Heydon's Case.

The Purposive Rule or The Rule in Heydon's Case

The purposive rule or the rule in Heydon's case, has at its core purpose, the discovery of the intent of Parliament or the legislator, namely,

What purpose was the statute enacted to rectify- for which the common law had a defect or needed to be rectified?

From the above-mentioned rules an evolvement of the role of judges is demonstrated – both in respect of a greater role given to judges to interpret according to the intent of the legislator, and also in respect of analytic reasoning and balancing.

It is quite understandable as regards why Hayek and Posner's backgrounds have considerably impacted their perspectives of the role of judges.

As will be illustrated under this section, the de centralization of the judicial process, through the participation of economic and non legal actors, as means of achieving judicial goals in the efficient allocation of resources, is acknowledged by Posner. Hence to the extent that both Posner and Hayek share the view that the decentralization of law respectively facilitates the attainment of goal of efficient resource allocation and promotes the rule of law, a consensus for the de centralization of rules is shared by Hayek and Posner.

According to Zywicki and Sanders,¹³

¹³ TJ Zywicki and AB Sanders, "Posner, Hayek & the Economic Analysis of Law" Iowa Law Review Volume 93 No 2, page 559

“Posner conceives law to be a series of disparate rules and as purposive. He believes that a judge should examine an individual rule and come to a conclusion about whether the rule is the most efficient available,” whilst Hayek is considered to “conceive law as a purpose independent set of legal rules bound within a large social order.”

These views will now be examined to a broader context under a landmark ruling which has not only contributed to judges’ abilities to introduce aids as a means of interpreting statutes to a more effective extent, but also demonstrates the interdependency of rules - from one social order to the next.

Pepper v Hart: The Mischief Rule and the Inclusion of Aids (Parliamentary Privileged Information) as a Means to Statutory Interpretation

Pepper v Hart¹⁴ represented a landmark ruling in the sense that it was the first time whereby the use of privileged parliamentary debates, information and records (Hansard) were permitted as admissible aids to statutory interpretation. The case involved the valuation of employee benefits for income tax purposes - given the ambiguous wordings of the statute involved. The following issues were raised in the case:¹⁵

- 1) Should existing rule prohibiting any reference to Parliamentary material (Hansard) in construing legislation be relaxed, and if so, to what extent?
- 2) If so, does the case fall within the category of cases where reference to Parliamentary proceedings should be permitted?
- 3) If reference to Parliamentary proceedings is permissible, what is the true construction of the statutory provisions?
- 4) If reference to Parliamentary proceedings is not permissible, what is the true construction of the statutory provisions?

As per Lord Browne-Wilkinson:

“Reference to Parliamentary material should be permitted as an aid to the construction of legislation which is ambiguous or obscure, or the literal meaning of which leads to an absurdity. Even in such cases, references in court to Parliamentary material should only be permitted where such material clearly discloses the mischief aimed at or the legislative intention lying behind the ambiguous or obscure words.”¹⁶

¹⁴ [1992] 3 WLR 1032, [1993] 1 All ER 42, HL (E)

¹⁵ **Pepper** (Her Majesty's Inspector of Taxes) v **Hart**. Decided, 26 November 1992. [1992] UKHL 3 [1993] AC 593 [1992] 3 WLR 1032

¹⁶ See *ibid*, also see S C Styles, “The Rule of Parliament: Statutory Interpretation After Pepper v Hart” Oxford Journal of Legal Studies Vol 14 No 1 (Spring 1994) pp 151-158 Oxford University Press

Section 63 of the 1976 Finance Act constituted the central piece of legislation in the case. It is obvious that in such cases – not just those cases involving contentious attributions to the construction of the piece of legislation, but those whose scope may lie beyond the scope and principal expertise of the judge, aids to statutory interpretation may be justified where such aids are vital to efficient allocation of resources, as well as generating outcomes which could be considered to be reasonably efficient within the ambit of legitimate expectations of the parties involved.

Should judicial decisions be criticised for generating more efficient and purposive outcomes particularly where the legislative source being referred to (regardless of whether such a source is privileged information), has not been altered in any sense, but has simply served as a means of shedding more light, providing more information, and giving purpose and meaning (or more meaning) to the legislation at hand?

The decision has been criticized from the perspective that it leads to rigidity in the application of of its judgment rather than the flexibility intended under the 1976 Legislation by Parliament. The ratio decidendi or principle decided, namely that “that the 'proper' proportion must always be the marginal cost”, in Bennion’s view, results in rigidity which could not have been intended by the legislators.

As concluded by Bennion:¹⁷

- Parliament, in adopting the wording of clause (6), must have contemplated not only that the conferred power of judgment would exercised by officials rather than Ministers (and on appeal or review the courts), but that it would produce answers that would be different in different cases and might, in the light of experience or changing circumstances, be varied over time.”

¹⁷ F Bennion, “How they all got it wrong in Pepper v. Hart”(1995), and HANSARD - HELP OR HINDRANCE? A Draftsman's View of Pepper v Hart (1995) <http://www.francisbennion.com/topic/peppervhart.htm>

C Harmonising Hayek and Posner: Decentralisation Through Non Legal Agents

De centring of rules, as well as information, has been increasingly taking place over the years – as evidenced by the engagement of legal, non-legal and economic actors in the rule making process and judicial process. This serves as testimony to the fact that judges may not be fully equipped to allocate information in such a way that maximal efficiency or the best outcome is derived for involved parties. As already highlighted under the introductory section, other non-legal actors such as financial experts are now being engaged as expert witnesses in deciding landmark judgments. The use of so called non legal actors to fill in gaps which are aimed at ensuring that judges acquire complete information which is fundamental to the efficient allocation of resources, is illustrated by the following extract from Posner’s statement:¹⁸

- The point I want to emphasize here is that the content of the legal norms that judges create by their decisions is not given by Kelsen’s concept of law. As one of his natural-law critics puts it, “How the judge arrives at his decision is [for Kelsen] a ‘meta-legal’ question without interest for the jurist.” Kelsen’s rejection of natural law, his emphasis on jurisdictional at the expense of substantive norms, his repeated references to judicial discretion, his claim that application of law is not mechanical but often involves “the creation of a lower norm on the basis of a higher norm,” his acknowledgment that sometimes the only preexisting law that a court can apply to decide a case is the law that confers the power of decision on the court, and his concept of interpretation as a frame rather than an algorithm, delimit a broad range of judicial action that is free (in the sense of “free range” chicken) yet lawful. The judges have to fill it with something, but while that something is lawful, it is not the law.”

The role of judges, hence has evolved to the extent whereby the expertise of non-legal actors, as well as the incorporation of non-legal medium, through decentralization, whether these constitute non-governmental organisations, or financial experts, are required to be engaged in the legislating and interpretation of the law, in order for such judicial capacities to attain their maximal potential.

The following section is aimed at highlighting Posner and Hayek’s consensus on the importance of decentralization, as well as the incorporation of non-legal actors as tools for facilitating the

¹⁸ See R.A.Posner, (2001) “Kelsen, Hayek, and the Economic Analysis of Law” at page 20

efficient allocation of resources in common law. Decentralisation and the involvement of non legal medium also serve to illustrate the evolution of common law from the more centralized role previously assumed by judges (now devolved through other non-legal actors) as well as the increased role being assumed by litigants through the need to ascertain those who value information rights the most. Whilst it is argued that litigants influence the evolution of common law,¹⁹ the role of judicial opinion in shaping the evolution of the system, is also emphasized.²⁰

The effectiveness of de centralization as an information gathering mechanism, employed in the judicial process is illustrated in the following statement by Posner:²¹

There are two ways of establishing norms to guide human behavior. In one, which Hayek calls “constructivist rationalism,” they are prescribed from the top down by a legislature, a bureaucracy, or a judiciary—in other words by experts who gather the information necessary to formulate by the method of reason the best possible set of norms. This method, as we might guess from Hayek’s aversion to central planning, he rejects as requiring too much information to be feasible; in addition, it endangers liberty by enlarging the administrative powers of government and thus weakening the rule of law.”

Posner further adds:²²

The alternative method of creating norms is that of custom, and is based on the superiority of what Hayek calls “spontaneous order” over order brought about by plan or design. The word “spontaneous,” with its connotation of suddenness, is not the best term for what he has in mind; “unplanned” or “undesigned” would be better and “evolved” would be best, given his emphasis on the analogy of natural selection.

The above statements, whilst reflecting support for de centralization, as well as the consensus of the evolutionary of the law, is to be contrasted with Posner and Hayek’s view of what roles should be assumed by economic actors and judges in the judicial process:

Whilst Posner highlights his support for Hayek’s view that law owes much to custom and that custom is a reliable guide to efficient methods of cooperation, he considers Hayek’s idea, “that the

¹⁹G L. Priest, "The Common Law Process and the Selection for Efficient Rules," 6 *Journal of Legal Studies* 65 (1977) page 63 and 72. Roubini agrees with Priest’s opinion on judges – his model focusses on decisions of potential and actual litigants rather than on judges driving the model.

²⁰ See DG Whitman, “Evolution of Common Law And the Emergence of Compromise *Journal of Legal Studies*, vol. XXIX (June 2000)] at page 781

²¹See R.A.Posner, (2001) “Kelsen, Hayek, and the Economic Analysis of Law Page 30

²² See *ibid* at page 31

only thing a judge should do is enforce custom, without any consideration of its consequences, because custom is the only legitimate law and so a legal judgment not founded on it is not true law”,²³ as being too narrow – adding that it “extinguishes any explicit role for economic analysis in adjudication.” Posner herein underlines his support for a more active (rather than passive role) to be assumed by judges.

He also distinguishes Hayek and Kelsen by adding that whilst Hayek, excludes the possibilities and position that economic analysis might occupy in adjudication, Kelsen, opens that space wide.

However, it appears that Hayek is also in favor of the engagement of non-legal actors in the judicial process. This is reflected where he states that “the ultimate decisions must be left to the people who know directly of the relevant changes and of the resources immediately available to meet them” – as well as his affirmation of the need of decentralization as a means of ensuring that “the knowledge of the particular circumstances of time and place will be promptly used.”

D Conclusion

“If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them.

We need decentralization because only thus can we ensure that the knowledge of the particular circumstances of time and place will be promptly used.”²⁴

In very interesting fashion, decentralization is also essential towards ensuring that possibilities for regulatory capture are minimised.

Why firms might want to allocate “property rights invaluable information” to managers, rather than to shareholders? Because centralisation of information in the ambit of those better equipped and specialised to handle such information warrants such a move.

Centralisation and decentralisation should thus be viewed from relative (as opposed to absolute) perspectives. Support for centralization of information is justified where such information resides within capable and more equipped ambits who will transform such information for the purposes of maximization of wealth or utilities. Given such merits, there still exists the need for checks and balance to ensure that such powers are not abused. In like manner, decentralization of information

²³ Which he regards as a slight exaggeration of his position, see *ibid* at page 37

²⁴ F A Hayek, “The Use of Knowledge in Society” *The American Economic Review*, Vol. 35, No. 4. (Sep., 1945), pp. 519-530

<http://www.jstor.org/discover/10.2307/1809376?uid=3739920&uid=2&uid=4&uid=3739256&sid=21104299293711>

may still be facilitated optimally taking into account timing, manner of the dissipation, and agents involved in the distribution of such information.

Judges should certainly not make and unmake the law in certain cases - the supremacy of Parliament should be adhered to. Judge made law, namely common law, however constitutes an exception where the principle of *stare decisis* cannot hold in a world which is constantly changing and where those changes need to be incorporated into decisions if such decisions are to generate meaningful results.

Prices, for example, constitute examples of vital information which need to be updated constantly if wages which were earned centuries ago, are to have meaningful and reasonable importance and values in modern day valuation and measurements. Markets will definitely evolve and adequate rules are needed to regulate the markets. This is very evident given the fact that market failures, namely information asymmetries exist, and also the fact that the Efficient Markets Hypothesis does not hold in its entirety. Decentralization, hence constitutes a means of not only mitigating information asymmetries, but also ensuring that efficient maximisation of resource utilisation and allocation, takes place.

Hence the decentralization of powers and information, in this case, from the executive and legislature to the judiciary, should be viewed positively as a means of addressing and mitigating informational asymmetries resulting from ambiguous, confusing and misleading words within a statute and also resulting in more efficient allocation of resources, and awarding of damages to the parties involved.

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