Legal Cases and Economic Reasoning – Introduction

• Polinsky‘s can of beans case
• Justice Traynor and the introduction of product liability Escola v. Coca Cola 1944
• Calabresi, 1961 to 1970 *The Costs of Accidents: A Legal and Economic Analysis*
• Coase, *The Problem of Social Cost* 1961
  „farmer/rancher; farmer/railroad cases“
Simple Economics

Behavioral Assumptions

**INDIVIDUALISM**

**Action:**
- Rational
- Self seeking
- Undisclosed preferences
- Zero transaction cost

**EFFICIENCY**
- People maximize
- Markets clear
- Moves make parties better off
- „Pareto superiority“
Qualifications

• Efficiency and/or Fairness?
• Bounded Rationality
• Pervasive Existence of Transaction Costs
• **Institutions matter!**
• Existence of Behavioral Anomalies

*Uncertainty and risk are fundamental for the existence of institutions*
Uncertainty and Risk

Famous book by Frank Knight (1921): „Risk, Uncertainty and Profit“

Kinds of uncertainty:
- primary uncertainty (we do not know the future)
- market uncertainty (information asymmetry)
Uncertainty and Risk

*Knight*: uncertainty does not contain probabilities; risk is related to known statistical events, probability analysis leading present values. Whereas risk can be insured, risk averse actors have to assume the incidence of an uncertain event in any future moment.
Uncertainty and Risk

Under risk, rational actors maximize discounted present values

Example: Investment

a) Safe return: Expected Monetary Value = 1\*(200)=200

b) Risky return, known probability 5/9*:  
\[ \text{EMV} = \frac{5}{9}\*(400) + (1-\frac{5}{9})\*(50) = 200 \]

Risk attitudes: risk proneness, neutrality, aversion; Lit. Cooter/Ulen chap.2 appdx.
Property Rights and Agency Costs

• Specification of property rights is central to achieve relative certainty
• Can be achieved by installing “institutions”

“he who sows must also be able to harvest”

concept of legal certainty
Property Rights and Agency Costs

- Wealth of Nations is driven by specialization, related markets and firms
- Specialization is expressed in "agency relations"

Principal monitors, agents act

Likelihood that agents will cheat because
(1) Incentive scheme is inadequate
(2) Agent is not properly screened
Literature

• M. Polinsky, An Introduction to Law and Economics 4th ed 2010