

Introduction to Law and Economics 1

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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 $5/9^*$:
EMV = $5/9*(400) + (1-5/9)*(50) = 200$

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

- R.A. Posner, *Economic Analysis of Law* 6th ed 2003
 - M. Polinsky, *An Introduction to Law and Economics* 3rd ed 2003
 - R. Cooter & T. Ulen, *Law and Economics* 4th ed 2004
- S. Shavell (2003), Miceli (1997), Schäfer & Ott (4th ed 2005), Assmann, Kirchner, Schanze (2nd ed 1993)*