Introduction to Law and Economics 2

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Application 1: Torts

Assignment: Polinsky re-read ch 1, read ch 3, 6,7,9.

• Justice Traynor, 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
Application 1: Torts

Calabresi, HarvLRev 1965 *Decision for Accidents*

Two main objectives of accident law:
Compensation of victims
Reduction of costs

*not*

*Reaction on personal responsibility for harmful behavior*
Application 1: Torts

Society makes decisions for accidents
We do not avoid accidents at any cost!
Political mechanisms:

market (lawn mowers) or
fiat (fire crackers)

Accident law should „internalize“ the costs of a harmful activity: (cf. Traynor, but method, detail)
Application 1: Torts

Excursus: Methods for internalizing externalities:
market failure (Pigouvian taxes)
regulatory failure (Coasean bargaining)

Normative assumption: prices should reflect all costs of an activity

Technology: hypothetical bargain cheapest cost avoider
Application 1: Torts

Two questions:
(1) What costs should be included? commercial loss, non-commercial interests?

(2) What are the costs of which activity? classes of activities needed

Allocation of costs by „comparisons“ and „involvement“
Application 1: Torts

Calabresi’s result:
Only strict liability (compensation)
\textbf{plus} criminal liability (prevention) in special cases
serves the purpose of a cost effective system of accident law

Critique (e.g. Posner): criterion of negligence is a better trigger for allowing compensation because strict liability encourages risky behavior on the side of the victims
Strict liability neglects the „reciprocal nature“ of accidents
### TABLE 7

#### Automobile Accident Example — Driver's Care Affects Expected Accident Cost

<table>
<thead>
<tr>
<th>Behavior of Driver</th>
<th>Benefit to Driver</th>
<th>Expected Accident Cost to Pedestrian</th>
<th>Benefit Minus Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drive rapidly</td>
<td>$120</td>
<td>$100</td>
<td>$20</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$(= 1/100 \times $10,000)$</td>
<td></td>
</tr>
<tr>
<td>Drive moderately</td>
<td>$80</td>
<td>$40</td>
<td>$40</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$(= 1/250 \times $10,000)$</td>
<td></td>
</tr>
<tr>
<td>Drive slowly</td>
<td>$50</td>
<td>$20</td>
<td>$30</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$(= 1/500 \times $10,000)$</td>
<td></td>
</tr>
</tbody>
</table>
Application 2: Contracts

Assignment: read Polinsky ch 5, 8.

Contract law as a set of „default“ rules - in view of incomplete contracting
Hypothetical bargains might intrude in the preference structure – „paternalism“
Asymmetrical information: “lemons problem”
What means “bargaining power” or “weaker party”?
Relation of “contract” and “agency”
Application 2: Contracts

A fully specified contract is efficient
Instant exchanges do not need a legal system
Only if a future performance is concerned the uncertainty must be channeled by institutions – courts, enforcement – but of what?
Breach of Contract – cf. Polinsky ch.5
Specific performance, or money damages?
If the primary remedy is money compensation, adverse action will be controlled by the “price” of nonperformance: “efficient breach”
Application 2: Contracts

Polinsky: distinction between expectation, reliance and restitution interests, and risk perception

*choice of remedy influences likelihood of breach*

Under civil law: judges will choose *specific performance* where the money assessment of creditor loss is too complex (costly)
Application 3: Corporations

Coase 1937 “Nature of the Firm”:
Transaction costs determine the choice between contract (market) or firm (hierarchy)
Alchian, Jensen, Meckling, Fama, Cheung:
corporation is a nexus of contracts
analysis of “agency relations”
   specifically between shareholders and managers (whose agents are managers?)
Nature of shareholding (special set of slides)
Beyond Corporations & Contracts

There are numerous “network” relations between firms that can be neither explained in terms of market nor hierarchy:

Hybrid transactional patterns that “use” features of both basic modes of transacting: consensus and majority rule, agreement and private legislation plus policing

Examples: franchising, work benches; joint ventures; quality circles

“symbiotic arrangements”
Conclusion

Law and economics is a science of institutional choice
Which allows deeper insights in the structure of transactions.
By analyzing the incentive structures
It is an advanced instrument of institutional design
Which will only work if the “institutional knowledge”
of the legal profession is merged with the analytical skills of the economics profession.