

# **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)

**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**

<i>Behavior of Driver</i>	<i>Benefit to Driver</i>	<i>Expected Accident Cost to Pedestrian</i>	<i>Benefit Minus Cost</i>
Drive rapidly	\$120	\$100  (= $1/100 \times \$10,000$ )	\$20
Drive moderately	\$80	\$40  (= $1/250 \times \$10,000$ )	\$40
Drive slowly	\$50	\$20  (= $1/500 \times \$10,000$ )	\$30

# 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?

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?)*

# 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.