

# An Introduction to Law and Economics

Lecture 1



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# History



- ▶ Before 1960's the use of economics limited to the areas of antitrust law, regulated industries, taxes, the determination of monetary damages

(Simons-tax law, Coase-public utility, Hale-contract law)

- ▶ After 1960's **New Law Economics**

Traditional areas as property, contracts, torts, criminal law and constitutional law

(Coase-social cost, Calabresi-torts, Becker-crime, racial discrimination, divorce, marriage, pioneers-Pigou and Bentham)

- ▶ Wide application of economics to law

Nobel Prize in economic analysis of law 1991, 1992 (Coase and Becker)

Deregulation movement in 70's (airlines, electric power), antitrust law US and EU



# What is the Economic Analysis of Law

- ▶ A law is an obligation backed by a state sanction

How will a sanction affect behavior?

Lawyers- intuition, available facts

Economists-the effect of legal sanction on behavior (sanctions=prices)

Example: manufacturer (cost of safety versus the implicit price of accidents)

- ▶ Positive Economic Analysis of Law

Explain legal rules, predict effects

- ▶ Normative Economic Analysis of Law

Evaluation of law and recommendation, *Pareto efficiency* of legal rule



# What is the Economic Analysis of Law

Law facilitates business transactions, but also constrains business activities  
(theft discouraging whereas exchange encouraging)

-ideal legal system-profitability of business and the welfare of people aligned

Law practice in firms:

Transactions (business deals)

Regulation (legal constraints)

Litigation (solution fo disputes by trials)



# Examples

▶ Example 1

**White-collar crimes** (monetary fine versus incarceration)

-gains versus costs of crime

The implicit price of sanction and effects on behavior

Economic efficiency-costs of crime to criminal justice?

Becker: "The most serious crime should be punished by the maximum monetary fine, which the offender can bear. (Incarceration inefficient)

▶ Example 2

An oil company from Middle East breaches the contract about oil delivery because of war, (contract silent about non-performance)

-the court- dispute resolution, rule creation

▶ Example 3-Eddie's electric company emits smoke, dirties the wash at Lucille's laundry

Cheaper to install filters (Lucille) than to install scrubbers (Eddie)

-no cooperation X cooperation (efficiency-Coase)



# The Primacy of Efficiency over Distribution in Analyzing Private Law

- ▶ This course-focuses on efficiency, rejects redistributive approach

**Redistributive approach to law**-targets social groups like poor, women, minorities, (class gender, race), redistribution through private law of property, contracts, torts

Economists-agree about redistributive means, but not ends

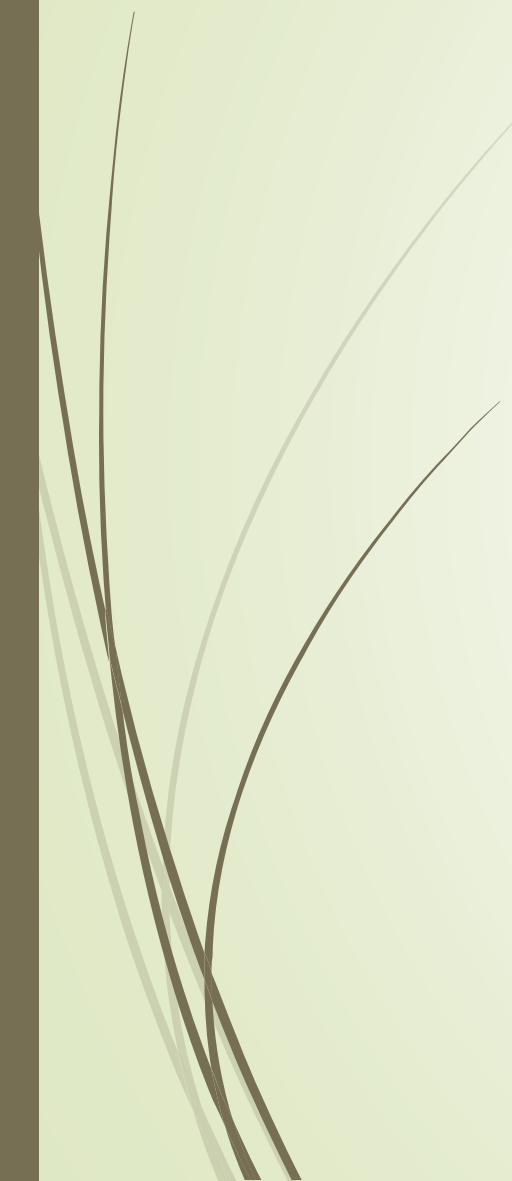
Example: Oasis 1 and 2 (ice-cream delivery)

- ▶ Economists: „Private legal rights wrong way to pursue redistribution.“
  - 1) Redistribution achieved more efficiently by tax and transfer system
  - 2) Distributive effect of modifying legal rights hard to predict
  - 3) The transaction costs of redistribution through law pretty high
  - 4) Redistribution through law distorts the economy more than taxation



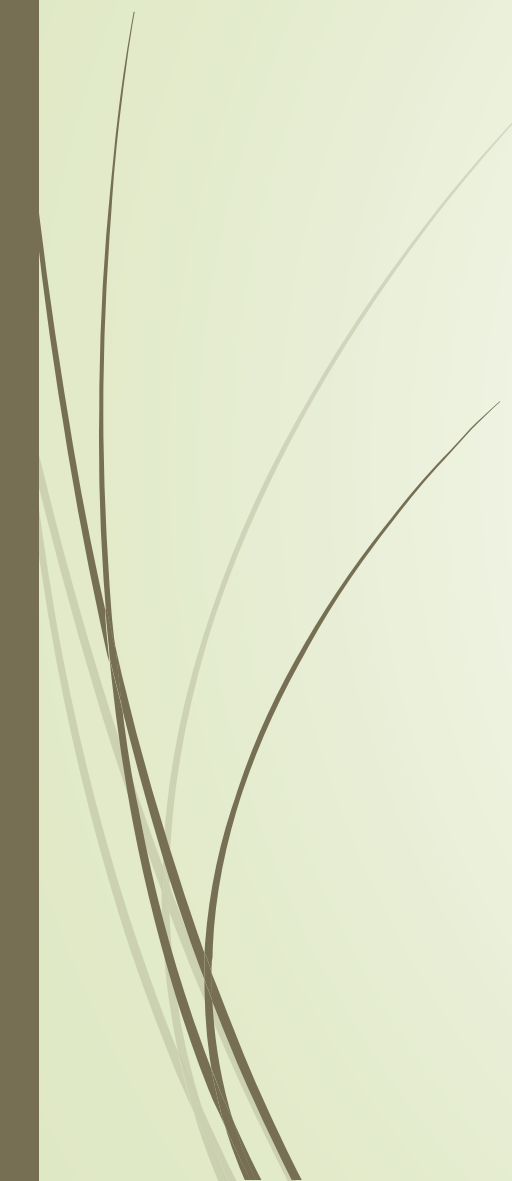


# Why Economics and Law?

- ▶ Economics-helps to perceive law in new way, because law provides incentives for changing behavior in form of implicit price, efficiency and distribution
  - ▶ Legal institutions, property, contracts-necessary for economics and growth
  - ▶ Economics can learn from lawyers to improve economic models
- 



# A Review of Microeconomic Theory

- ▶ The structure of economic theory
  - ▶ Maximization, equilibrium and efficiency
  - ▶ Mathematical tools
  - ▶ The theory of consumer choice and demand
  - ▶ Theory of supply
  - ▶ Market equilibrium
  - ▶ Game theory
  - ▶ Theory of asset pricing
  - ▶ General equilibrium and welfare economics
  - ▶ Market failure
  - ▶ Potential Pareto Improvements
  - ▶ Decision-making under uncertainty
  - ▶ Profits and growth
- 





# Market Failure

- ▶ Monopoly and market power
- ▶ Externalities (nuisance)

Internalization of externality or free market solution


- ▶ Public goods

non-rival, non-excludable (national defense)

- ▶ Information asymmetries

Sellers know about the quality more than buyers

(disclose knowledge about effects otherwise responsible)



# Potential Pareto Improvements (Kaldor-Hicks efficiency)

- ▶ Productive efficiency

It is impossible to produce the same amount of output using a lower-cost combination of inputs, it is impossible to produce more output using the same combination of inputs

- ▶ Pareto efficiency

- ▶ Pareto superiority

At least one person is made better off and no one else is made worse-off (gainers explicitly compensate losers)

- ▶ Potential Pareto improvement

Changes in which gainers gain more than the losers lose, gainers can compensate and still surplus, (no need for compensation but it must be possible)

Example: manufacturing plant moved from city A to city B



# Decision-making under Uncertainty

Market for insurance (reduces the risk)

- ▶ Moral Hazard

The behavior of insuree changes after the purchase, the probability of loss increases (reduction through coinsurance or deductibles)

- ▶ Adverse Selection

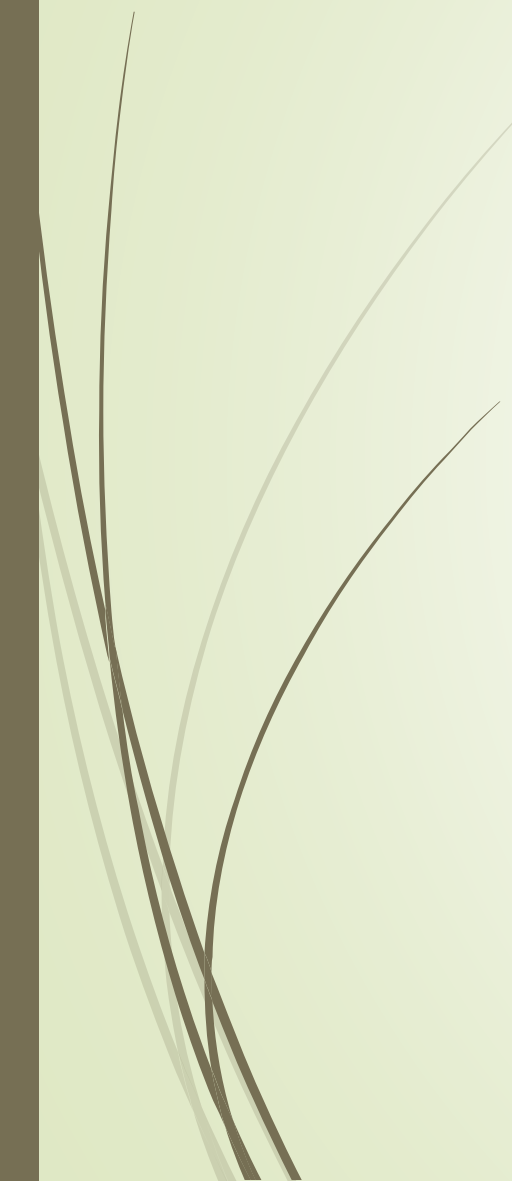
Individuals with better private information about the quality of a product will selectively participate in the most beneficial transaction

Example: health insurance the same for smokers and non-smokers

Health insurance different (higher insurance premium for smokers)



# An Introduction to Law and Legal institutions

- ▶ The Civil Law and the Common Law traditions
  - ▶ The institutions of federal and the state court system
  - ▶ The nature of legal dispute
  - ▶ How legal rules evolve
- 



# Civil and Common Law

- ▶ Legislatures-make laws by enacting bills, judges interpret, apply
- ▶ Choice of interpretation overshadows the enactment of the bill-making the law
- ▶ The courts of English king
  - issue pronouncements, examine community life and find the law as it existed
  - the law of nature**-select among prevailing social norms, enforce them
  - precedent**-finding the rule of law, future courts expected to follow
- ▶ **Common law** -rooted in the common practices of people  
(laws in area of crimes, property, contracts, torts)
- ▶ **Civil law**-18th century French revolution, 1804 the Code of Napoleon, (The Body Civil Law), pure reason for law, the civil law tradition



# The Difference between Civil and the Common Law

- ▶ Common law judges

- rely on past court decision-rely on precedent

- the law taught by reading cases and arguing from them

- during dispute-arguments exclusively made by lawyers, judge neutral referee (rules of procedure and evidence)

- juries-questions of the fact (both parties have the right, but sometimes let only the judge to decide-questions of the law)

- ▶ Civil law judges

- interpretation of a code directly by reference to its meaning, rely on words in statutes

- the law taught by reading the code and arguing from commentaries during dispute-inquisitorial process

- during dispute-judge active role, lawyers respond to judge, the court finding the truth

- Jury (in UK abolished in civil trials, but often used in criminal trials, in France completely abolished)





# Civil Law and Common Law

- ▶ Overlapping of common law and civil law

US Uniform Commercial Code-many similarities with the French Civil Code or Restatement of Contracts and Torts-civil law

Hierarchy of laws (the constitution, statutes, rules)


- ▶ Making the law by judges

-judges interpret the law by statutes and codes

-taking precedence-the higher law prevails in the even of conflict

-does the law conflict? Set aside the lower-level law

-common law system-common law directly



# The Institutions of the Federal and the State Court System in USA

- Trial courts of general jurisdiction
- Federal district court
- Several specialized tribunals-Federal Communication Commission
- Appellate courts
- Intermediate appellate courts
- Court of last resort
- Higher appellate courts
- The Supreme Court of the USA
- ▶ Jurisdiction of state courts-disputes state statutes or civil actions
- ▶ Jurisdiction of federal courts-federal questions (US constitution, federal laws, treaties)
- ▶ Selection of judges

**Federal bench** -appointment by president, consent of the senate, life tenure, removal only by impeachment

**State judges** -the rule-election to the bench, limited tenure



# The Nature of Legal Dispute

- ▶ Cause of action

Valid legal claim against another person/organization

- ▶ plaintiff fills complaint, defendant must answer
- ▶ satisfactory mutual agreement X dispute proceeds to the trial
- ▶ Bench trial
- ▶ Preponderance of the evidence

If plaintiff's arguments more believable-he wins

-guilty beyond reasonable doubt-criminal proceedings

-clear and convincing evidence-civil cases or punitive damages

- ▶ Verdict-which party wins
- ▶ Judgement

Enter the judgment on the verdict (controlling action of the court), in rare cases „judgment non obstante verdicto“

- ▶ Appeal-the court made mistake about the relevant law but not about the facts
- ▶ The appellate court-confirms or reverses



# How Legal Rules Evolve

- ▶ Butterfield v. Forrester

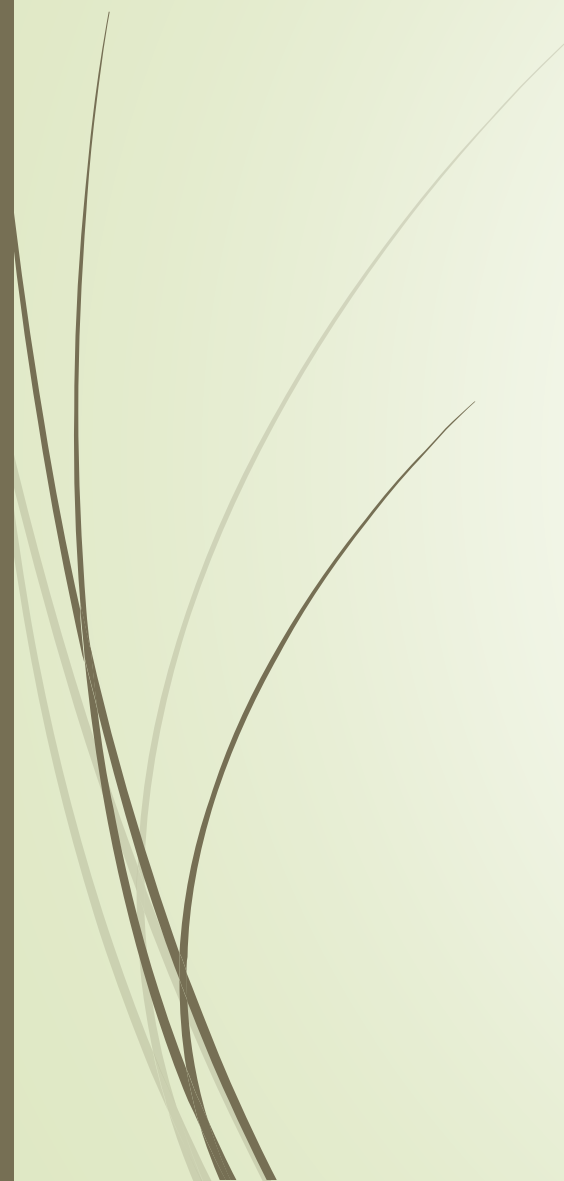

Riders of horses cannot recover money damages if they are not riding with ordinary care and this lack of care contributes to accident

-broader interpretation-no plaintiffs can recover if their own negligence contributes to their injury

- ▶ Davies v. Mann

„last clear chance rule“-the party who had the last clear chance to avoid the accident will be responsible for losses arising from the accident

(although the plaintiff left donkey unattended close to public highway)



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