

Lecture 1, 2, 3

Introduction to Economic Principles

Nurgul Tilenbaeva

American University - Central Asia

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Why Should Economists Study Law?

Introduction

- The role of economics in law was limited until recently:
 - ▶ antitrust law;
 - ▶ regulated industries;
 - ▶ tax;
 - ▶ monetary damages.
- Typical questions asked:
 - ▶ *What is the defendant's share of the market?*
 - ▶ *How much future income did the children lose because of their mother's death?*
 - ▶ *Will price controls on automobile insurance reduce its availability?*

Introduction

- Early 1960s: economic analysis of law expanded into the more traditional areas of law:
 - ▶ property;
 - ▶ contracts;
 - ▶ torts;
 - ▶ criminal law and procedure;
 - ▶ constitutional law.
- Typical questions asked:
 - ▶ *What remedy for breach of contract will cause efficient reliance on promises?*
 - ▶ *Do businesses take too much or too little precaution when the law holds them strictly liable for injuries to consumers?*
 - ▶ *Will harsher punishments deter violent crime?*

Introduction

Economics has changed the nature of legal scholarship, the common understanding of legal rules and institutions, and even the practice of law.

Professor Bruce Ackerman of the Yale Law School described the economic approach to law as

"the most important development in legal scholarship of the twentieth century".

What is the Economic Analysis of Law?

There are many ways of looking at a legal system, among them the perspective of a:

- legal historian;
- legal philosopher;
- lawyer interested in creating arguments courts will accept or contracts they will enforce.

The approach of the economist is to understand systems of legal rules by asking what consequences they will produce in a world in which rational individuals adjust their actions to the legal rules they face.

What is the Economic Analysis of Law?

Legal rules exist, at least in large part, in order to change how the people affected by them act.

- A speed limit exists because someone wants people to drive more slowly.
- The legal rule that holds that any ambiguity in a contract is to be interpreted against the party who drafted it exists because someone wants people to write contracts more carefully.

What is the Economic Analysis of Law?

The economic approach works in two directions:

- 1 Starting with an objective, it provides a way of evaluating legal rules, of deciding how well they achieve that objective.
- 2 Starting with a legal rule, or a system of legal rules, it provides a way of understanding it - by figuring out what objective it is intended to achieve.

What is the Economic Analysis of Law?

- The central assumption of economics is **rationality** - that behavior can best be understood in terms of the purposes it is intended to achieve.
 - ▶ A mugger is a mugger for the same reason I am an economist:
 - ★ Given his tastes, opportunities, and abilities, it is the most attractive profession open to him.
 - ▶ What laws are passed, how they are interpreted and enforced, ultimately depend on what behavior is in the rational interest of legislators, judges, and police.

What is the Economic Analysis of Law?

- The secondary assumption is that systems of legal rules make sense - that they can be understood as tools with purposes.
 - ▶ However, a system of legal rules is not entirely, perhaps not chiefly, the product of deliberate human design.
 - ▶ To a considerable extent it represents the unplanned outcome of a large number of separate decisions, by
 - ★ legislators bargaining over particular provisions in the law;
 - ★ judges trying to find and justify verdicts for particular cases.
 - ▶ It is therefore possible that such a system may have no objective for us to find.
 - ▶ There is no guarantee that we will be able to make sense of any particular system of legal rules, since there is no guarantee that it makes sense.

What is the Economic Analysis of Law?

- Lawmakers often ask, "*How will a sanction affect behavior?*"
 - ▶ If punitive damages are imposed on the maker of a defective product, what will happen to the safety and price of the product in the future?
 - ▶ Will the amount of crime decrease if third-time offenders are automatically imprisoned?
- Lawyers answered such questions by consulting intuition and any available facts.

What is the Economic Analysis of Law?

- Economics provided a scientific theory to predict the effects of legal sanctions on behavior.
 - ▶ Sanctions look like prices, and presumably, people respond to these sanctions much as they respond to prices.
 - ★ People respond to higher prices by consuming less of the more expensive good.
 - ★ Presumably, people also respond to more severe legal sanctions by doing less of the sanctioned activity.
 - ▶ Economics has mathematically precise theories (price theory and game theory) and empirically sound methods (statistics and econometrics) for analyzing the effects of the implicit prices that laws attach to behavior.

What is the Economic Analysis of Law?

You live in a state where the most severe criminal punishment is life imprisonment. Someone proposes that since armed robbery is a very serious crime, armed robbers should get a life sentence.

- A constitutional lawyer asks whether that is consistent with the prohibition on cruel and unusual punishment.
- A legal philosopher asks whether it is just.
- An economist points out that if the punishments for armed robbery and for armed robbery plus murder are the same, the additional punishment for the murder is zero - and asks whether you really want to make it in the interest of robbers to murder their victims.

What is the Economic Analysis of Law?

Legal rules are to be judged by the structure of incentives they establish and the consequences of people altering their behavior in response to those incentives.

- Speeding fines are intended, not as an odd sort of tax, but as a way of making it in the interest of drivers to drive more slowly.
- Tort law determines what happens to people who get in auto accidents and thus affects the incentive to do things that might lead to being in an auto accident, such as not having your brakes checked, driving drunk, driving at all.
- Divorce law determines under what circumstances you can get out of a marriage, which is one of the things relevant to deciding whether to get into it.

What is the Economic Analysis of Law?

Example: Suppose that a manufacturer knows that his product will sometimes injure consumers. How safe will he make the product?

- For a profit-maximizing firm, the answer depends on three costs:
 - ① the cost of making the product safer, which depends on its design and manufacture;
 - ② the manufacturer's legal liability for injuries to consumers;
 - ③ the extent to which injuries discourage consumers from buying the product.

⇒ The profit-maximizing firm will adjust safety until the cost of additional safety equals the benefit from reduced liability and higher consumer demand for the good.

What is the Economic Analysis of Law?

- Economics predicts the effects of laws on:
 - ▶ *efficiency*;
 - ▶ *distribution of income*.

Examples

- 1 We try to identify the implicit price that the legal rule attaches to behavior in each example.
- 2 We predict the consequences of variations in that implicit price.
- 3 We evaluate the effects in terms of efficiency and, where possible, distribution.

Examples

Example 1: *An oil company contracts to deliver oil from the Middle East to a European manufacturer. Before the oil is delivered, war breaks out and the oil company cannot perform as promised. The lack of oil causes the European manufacturer to lose money. The manufacturer brings an action (that is, files a lawsuit) against the oil company for breach of contract. The manufacturer asks the court to award damages equal to the money that it lost. The contract is silent about the risk of war, so that the court cannot simply read the contract and resolve the dispute on the contract's own terms. The oil company contends that it should be excused from performance because it could do nothing about the war and neither of the contracting parties foresaw it. In resolving the suit, the court must decide whether to excuse the oil company from performance on the ground that the war made the performance "impossible", or to find the oil company in breach of contract and to require the oil company to compensate the manufacturer for lost profits.*

Examples

War is a risk of doing business in the Middle East that one of the parties to the contract must bear, and the court must decide which one it is.

- What are the consequences of different court rulings?
 - ▶ The court's decision simultaneously accomplishes two things:
 - ① It resolves the dispute between the litigants - "**dispute resolution**".
 - ② It guides future parties who are in similar circumstances about how courts might resolve their dispute - "**rule creation**".
- The oil company and the manufacturer can take precautions against war in the Middle East, although neither of them can prevent it.
 - ▶ The oil company can sign backup contracts for delivery of Venezuelan oil.
 - ▶ The manufacturer can store oil for emergency use.

Examples

War is a risk of doing business in the Middle East that one of the parties to the contract must bear, and the court must decide which one it is.

- Efficiency requires the party to take precaution who can do so at least cost.

Is the oil company or the manufacturer better suited to take precautions against war?

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- Since the oil company works in the Middle East, it is probably better suited than a European manufacturer to assess the risk of war in that region and to take precautions against it.
- For the sake of efficiency, the court might hold the oil company liable and cite the principle that courts will allocate risks uncovered in a contract to the party who can bear them at least cost.
 - ▶ This is the principle of the *least-cost risk-bearer*.

Examples

Example 2: *Eddie's Electric Company emits smoke that dirties the wash hanging at Lucille's Laundry. Eddie's can completely abate the pollution by installing scrubbers on its stacks, and Lucille's can completely exclude the smoke by installing filters on its ventilation systems. Installing filters is cheaper than installing scrubbers. No one else is affected by this pollution because Eddie's and Lucille's are near to each other and far from anyone else. Lucille's initiates court proceedings to have Eddie's declared to be a "nuisance". If the action succeeds, the court will order Eddie's to abate its pollution. Otherwise, the court will not intervene in the dispute. What is the appropriate resolution of this dispute?*

Examples

- Efficiency requires Lucille's to install filters, which is cheaper than Eddie's installing scrubbers.

How can the court produce this result?

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- The answer depends on whether or not Eddie's and Lucille's can cooperate.
 - ① Assume that Eddie's and Lucille's cannot bargain together or cooperate.
 - ★ If Lucille's wins the action and the court orders Eddie's to abate the pollution, Eddie's will have to install scrubbers, which is inefficient.
 - ★ If Lucille's loses the action, then Lucille's will have to install filters, which is efficient.
- ⇒ It is efficient for Lucille's to lose the action.

How can the court produce this result?

- The answer depends on whether or not Eddie's and Lucille's can cooperate.
 - ② Assume that Eddie's and Lucille's can bargain together or cooperate.
 - ★ Their joint profits (the sum of the profits of Eddie's and Lucille's) will be higher if they choose the cheaper means of eliminating the harm from pollution.
 - ★ When their joint profits are higher, they can divide the gain between them in order to make both of them better off.
 - ★ The cheaper means is also the efficient means.
 - ★ Efficiency is achieved in this example when Lucille's and Eddie's bargain together and cooperate, regardless of the rule of law.

Examples

Example 3: *Standard of proof: In order for you to be convicted of a crime or to lose a civil case and have to pay damages, just how strong must the evidence against you be?*

Examples

It is tempting to reply that nobody should be punished unless we are certain he is guilty.

- But by that standard nobody would ever be punished; the strongest evidence establishes only a probability.
- Even a confession is not absolute proof.
- Scientific evidence is no more conclusive.
 - ▶ Even if we somehow had a perfect match between the DNA of the suspect and the criminal, there would still be the possibility that someone at the lab made a mistake, etc.

Examples

If we are to convict anyone at all, we must do it on evidence short of absolute proof.

How far short?

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How far short?

- Raising the standard of proof reduces the chance of convicting an innocent defendant but increases the chance of acquitting a guilty one.
- Whether it is worth doing depends on the relative costs of the two kinds of mistakes.
 - ▶ If it is better that ten guilty men go free than that one innocent to be convicted, we should keep raising our standard of proof as long as doing so saves one more innocent defendant at the cost of freeing no more than ten guilty ones.
⇒ We would end up with a high standard.

Examples

Example: law in the United States and similar systems requires:

- a high standard of proof ("beyond a reasonable doubt") in a criminal case;
BUT
- only a low standard ("preponderance of the evidence") in a civil case.

Why?

Why?

Economics suggests a simple explanation.

- The typical result of losing a lawsuit is a cash payment from the defendant to the plaintiff.
 - ▶ A high error rate in civil cases means that sometimes I lose a case I should have won and pay you some money and sometimes you lose a case you should have won and pay me some money.
 - ▶ On average, the punishment itself imposes no net cost; it is simply a transfer.
- The result of being convicted of a crime may well be imprisonment or execution.
 - ▶ A high error rate in criminal cases means that sometimes I get hanged for a murder I didn't commit and sometimes you get hanged for a murder you didn't commit.
 - ▶ In the criminal case, unlike the civil case, one man's loss is not another man's gain.
 - ▶ Punishment is mostly net cost rather than transfer, so it makes sense to be a good deal more careful about imposing it.

Examples

Example 4: *the nonwaivable warranty of habitability, a legal doctrine under which some courts hold that apartments must meet court-defined standards with regard to features such as heating, hot water, sometimes even air conditioning, whether or not such terms are provided in the lease - indeed, even if the lease specifically denies that it includes them.*

What are the effects of it?

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- The immediate effect is that certain tenants get services that their landlords might not otherwise have provided.
 - ▶ Some landlords are worse off as a result; some tenants are better off.
- In the longer run the effect is quite different.
 - ▶ Every lease now automatically includes a quality guarantee.
 - ▶ This makes rentals more attractive to tenants and more costly to landlords.
 - ▶ The supply curve, the demand curve, and the price, the rent on an apartment, all shift up.
 - ▶ The question, from the standpoint of a tenant, is not whether the features mandated by the court are worth anything but whether they are worth what they will cost.

What are the effects of it?

- In the longer run, the effect is quite different.
 - ▶ The answer may well be no.
 - ▶ If those features were worth more to the tenants than they cost landlords to provide, landlords should already be including them in their leases - and charging for them.
 - ▶ If they cost the landlord more than they are worth to the tenant, then requiring them and letting rents adjust accordingly is likely to make both landlord and tenant worse off.
 - ▶ It is particularly likely to make poorer tenants worse off, since they are the ones least likely to value the additional features at more than their cost.

What is the Economic Analysis of Law?

- ① One objection to the economic approach to understanding the logic of law is that law may have no logic to understand.
- ② Another objection is that law has a logic but that it is concerned not with **economic efficiency** but with **justice**.
 - ▶ We punish criminals not, or at least not entirely, because doing so achieves good consequences but because criminals deserve to be punished.
 - ▶ We require tortfeasors to make their victims whole not because doing so gives people an incentive not to be tortfeasors but because it is just that he who did the damage should pay for it.

What is the Economic Analysis of Law?

There are two answers to that:

- 1 Justice does not give an adequate account of law:
 - ▶ it is irrelevant to a large number of legal issues;
 - ▶ we have no adequate theory of what makes some rules just and some unjust.
- 2 In many cases it turns out that the rules we thought we supported because they were just are in fact efficient.

The Primacy of Efficiency over Distribution in Analyzing Private Law

Why private law should be based on *efficiency* rather than *redistribution*?

- 1 Imprecise targeting.
 - ▶ Income tax precisely targets inequality, whereas redistribution by private legal rights relies on crude averages.
- 2 Unpredictable consequences.
 - ▶ The courts cannot be confident that holding a corporation liable to its consumers will reduce the wealth of its stockholders.
 - ▶ Perhaps the corporation will pass on its higher costs to consumers in the form of higher prices, in which case the court's holding will redistribute costs from some consumers to other consumers.

The Primacy of Efficiency over Distribution in Analyzing Private Law

Why private law should be based on *efficiency* rather than *redistribution*?

③ High transaction costs.

- ▶ A plaintiff's attorney working on a contingency fee in the United States routinely charges one-third of the judgment.
- ▶ If the defendant's attorney collects a similar amount in hourly fees, then attorneys for the two sides will absorb two-thirds of the stakes in dispute.

④ Distortions in incentives.

- ▶ Redistribution by private law distorts the economy more than progressive taxation does.
- ▶ *Example:* Assume that a law to benefit consumers of tomatoes causes a decline in the return enjoyed by investors in tomato farms.
 - ★ Investors will respond by withdrawing funds from tomato farms and investing in other businesses.
 - ★ The supply of tomatoes will be too small and consumers will pay too high a price for them.
 - ★ ⇒ This law distorts the market for tomatoes.

Why Should Lawyers Study Economics?

Why Should Economists Study Law?

- Many people think of laws as promoting *justice*.
- Economics conceives of laws as *incentives* for changing behavior (implicit prices) and as instruments for policy objectives (efficiency and distribution).
- However, economic analysis often takes for granted such legal institutions as property and contract, which dramatically affect the economy.
- Improving the effectiveness of law in poor countries is important to their economic development.
- Law needs economics to understand its behavioral consequences, and economics needs law to understand the underpinnings of markets.

Why Should Lawyers Study Economics?

Why Should Economists Study Law?

- Economists and lawyers can also learn techniques from each other.
 - ▶ From economists, lawyers can learn quantitative reasoning for making theories and doing empirical research.
 - ▶ From lawyers, economists can learn to persuade ordinary people.