

# LAWS90187 Econ Analysis of Law

What are the assumptions of the economic discipline?

- Methodological individualism: Focus on indiv behaviour cf systems or neuro-cognitive mechanisms
- Resources are scarce
  - Preferences
  - Restrictions & incentives
- Indiv actors behave rationally (max utility)
  - Utility theorem: every decision-maker has a subjective, 'inner' utility function which assigns a distinct value to every possible choice
    - Usually pos. but decreasing marginally utility
    - Risk aversion
  - Rationality assumption: decision-makers act rationally in the sense that they invariably choose the option that yields the highest utility
    - Sometimes assume complete info
- Limits
  - Empirical challenges
  - Biases & non-rational behaviour
  - ➔ Relaxing the assumptions: the behavioural turn
- Welfare Analysis & Efficiency
  - Pareto efficiency: a given situation A is better than an alternative situation B if after comparison of the subjective individual preferences at least one individual is better off in situation A, while no individual is worse off
    - Problem: Pareto optimality does not consider the initial distribution of goods and may therefore give rise to fairness concerns.
  - Kaldor/Hicks efficiency: a policy change is welfare-enhancing if the gains of the better-off individuals would be sufficient to compensate the losses of the worse-off individuals, and if at least one individual would be better off after compensation
    - Problems:
      - how can a state of the world be preferable to another one if the losers are not actually redressed?
      - If we measure the allocation of gains and losses (and with it the necessary compensation) by the willingness to pay of the individuals concerned, then more affluent individuals are privileged
      - As the compensation is not measured in utility, but in monetary terms, what we consider may not be societal welfare, but only a hypothetical willingness to pay

How are they different from legal reasoning?

What sort of normative implications, if any at all, can be validly derived from the economic analysis of law?

Rationality assumption

- Every indiv is rational in sense that they'll look at what are the options available & choose the 1 that gives them the greatest benefit w/ least cost

Info is costly to acquire. Thus it's wrong to assume perfect info in almost any setting

We also don't assume perfect info processing ability.

- Skill of processing info is costly

Remember benefit includes intangible benefit

- In situations that might appear to be irrational, what may actually be happening is that the decision-maker simply has weird/unusual tastes/preferences (utility function), and that they are indeed behaving rationally IAW that utility function
  - Thus, rather than seeing this as criticising these decisions as being irrational, it may be more appropriate to see this as objecting against the utility function.
  - E.g.: LV bag – some ppl develop a preference for the LV brand via advertising, branding etc., thus forging the utility function
- ➔ Remember: changing people's utility function can be a powerful way to shape behaviour

“One of the powerful feats of the economic paradigm is that its positive theory actually allows one to derive *empirically testable hypotheses*.”

- IOT avoid complicating the model, we could assume perfect info in situations where info is cheaply, widely, and easily accessible. <- Economists
- For this subject, we don't need to be concerned w/ empirically testable hypotheses. Rather, we are here to look more closely at the immense variety of ways that indivs can react to the law (rather than just obey vs disobey). Not concerned w/ testing, but rather understanding the complexity of human behaviour wrt the law.

Note: the economic discipline generally lacks the capacity to engage in analysis of ethics/morality etc.

### Coase Theorem

If transact cost is low, law doesn't matter. The socially efficient outcome will always be reached.

Example: factory causes \$1000 dmg to farm via pollution. It costs \$200 to install a filter.

- Law must internalise externality: impose a private marginal cost
- Alternatively state could subsidise the filter
- Without law, farm would negotiate with factory to pay the factory to install the filter.

Given this, state may wish to seek to reduce transaction costs. This is an alternative course of action to simply imposing laws to regulate behaviour.

However, remember that it matters to the indiv parties which cse of action is taken – we must consider the redistributive outcomes of the different cses of action.

- For this subject, we need to ID who wins and who loses (we won't analyse who deserves it more).

Additional considerations: the indiv parties will also invest in trying to shape the law to benefit themselves.

- E.g. farm could choose to bribe regulator, lobby politicians to change the law etc.

## Class 1

Rationality: the rationality used in econ has a few qual's which makes it a bit diff fm lay meaning of rationality

- A pers will seek to max their utility. Will asses their options & chose what makes him happiest w/ least cost.
  - However, we don't assume perfect info. Pers must assess whether even accessing the info is worth it.
  - We also don't assume perfect info processing ability. Gaining info processing ability (e.g. legal training) can be very costly.
  - We all have certain quirks which can be weird or even bad/evil, however that doesn't necessarily mean we don't act rationally – they become part of our utility function.

A definition must be fit for purpose.

Hypotheses must be empirically testable, thus requiring additional caveats to make the rationality assumption more manageable: e.g. assume perfect info and/or processing ability, limit utility to material gain, etc. However, the more restrictions we put in, the more we dept fm real world, but that doesn't mean the model isn't valuable.

Economic analysis allows more accurate predictions for how ppl might behave wrt certain laws.

Law doesn't matter if transact cost is low. Instead of simply forcing harm-doer to internalise the cost of the harm, lowering transact cost can be another viable option.

Even if law has no social efficiency impact or is socially efficient, it can have distributive impacts – we must still pay attention to who wins & who loses. Economic analysis can't tell us who SHOULD win/lose, but it can tell us who WOULD win/lose.

## Class 2: Contract Law – CLASS NOTES

### Econ function of contract law

#### W/out contract law

Possible reactions:

- Instantaneous T'fer - focus on the present (extra checking before purchase)
  - Downside: prevents parties fm engaging in long term commitments
- Reputation will become important
  - Downside: final period problem – towards end of when vendor plans to trade, the constraint of reputation no longer exists (it's in their interest to manipulate their good reputation to make a killing by ripping off their customers – it doesn't matter any more since they're about to finish trading anyway)
  - Downside: how to get the reputation out? Not too much of an issue now w/ Internet, however the system can be gamed (fake positive/negative reviews)

- Deposit
  - Downside: cumbersome
  - Note: no longer as much of an issue these days at hotels due to hotels collecting CR card details. CR card coy provides a bridge b/w hotels & guests (3<sup>rd</sup> party intermediary - below).
- 3<sup>rd</sup> Party Intermediary
  - Downside: they usually take some kind of transact fee

Contract law can help to address the above downsides

Note: simply trying to improve access to cts can be of only ltd effectiveness – even if it's completely free, it's still a big hassle

### Stickiness of default terms

Default terms save time. Parties can form the contract w/out having to deliberate over, e.g. risk.

It increases the chance that the contract is enforceable (if certain key terms are absent fm the contract, the cts can't enforce it due to uncertainty).

A good default term would also consider issues such as risk allocation (allocating risk to superior risk-bearer).

Risk prima facie passes w/ property – gap filling term: makes contract easier to be formed (reduces negotiation cost)

E.g.: sale under voidable title (buyer can gain good title if bought in good faith even if seller didn't have title to the goods) – encourages buyers to buy (eliminates some of their risk: they can keep the goods w/out worrying about litigation if seller doesn't have good title); buyers don't need to spend as much time investigating the goods before purchasing.

- Winner: buyer
- Loser: someone who may have better title
- No option to opt-out, b/c:
  - Impossible to
  - It's meant to tackle a social issue: facilitating transactions (is meant to make things easier for society), not gap filling - trying to make transactions easier across the board w/ some loss to the property owner, but overall society benefits b/c there are more transactions.
- This cl is aimed at facilitating transactions, & solves redistributive problem (buyers will often become sellers, & thus many players will win some & lose some. Overall, over a period of time, there is no net loss.)

Sale of sheep skins provision – 3<sup>rd</sup> party not involved; law tries to benefit a particular party over the other party, both being contractual parties.

A default term is good if, in most contracts, parties don't opt out of it.