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Econ 280—Bethany College

**Lecture 12: Law and Economics**

1. The purpose of law
	1. Law and economics is a specialization in economics which approaches the law as a way to encourage economic efficiency.
	2. We cover it here because much actual law—especially laws pertaining to businesses—can be understood through this framework.
2. The Coase theorem
	1. When it comes to the traditional approach to negative externalities—taxing or subsidizing them—Coase made two critical points.
		1. Making the polluter pay isn’t always efficient. Since it takes two to have an externality, it is sometimes cheaper to move or punish the pollutee rather than the polluter.
		2. Externalities do not always lead to an inefficient result. As long as parties can trade and the court rules who’s in the right, exchange will lead to efficiency.
3. Contracts
	1. A contract is an agreement supported by “consideration.”
		1. By agreement we mean that one party proposed an exchange and the other accepted.
		2. By consideration we mean that one party gives something to another party. If you buy a car for $9,000, the car is the consideration for the $9,000 and the $9,000 is the consideration for the car.
	2. Contracts are used to reduce transaction costs. By making committed promises, parties can make plans based on those promises.
		1. For example, a buyer will make a contract with a seller, promising to buy a certain number of items. Assured by the contract, the seller is willing to build the factory and buy the inputs to make the items.
4. Invalidity
	1. A contract can be rendered invalid in several ways. Much of contract law involves incentivizing people to seek out and use relevant information.
	2. It involves illegal activity. Contracts make it easier or possible to do business. By baring illegal activity from contracts, the court makes this activity more expensive to accomplish.
		1. That one about the deception case.
	3. Misrepresentation . Also known as fraud, misrepresentation involves deception concerning the product being sold (lying, painting over termite holes in a house). Since we assume the buyer knows more about the item being sold than the seller, incentivizing the seller to be honest makes sense.
		1. In *Vokes v. Arthur Murray, Inc.* (1968), a fifty-one-year-old Florida woman signed up for dance lessons. Encouraged by instructors that she had the potential to be an excellent dancer, she signed up for more, and more, and more lessons. Over fourteen contracts, she signed up for over 2,300 hours. Then she realized she was probably being deceived. The court threw out the contracts. While the studio can encourage Vokes, the court ruled they had crossed the line.
	4. Coercion. You can’t make a contract under an improper threat. This obviously includes force but it also includes refusing to complete the contract unless additionally compensated. Ignoring these demands reflects that the contract was made under mutual agreement and is thus mutually beneficial as it stands.
		1. In ???? (1900s), a cannery hired San Fransisco workers to go to Alaska to catch fish. When the workers arrived, they refused to work until they “renegotiated” the contract. The employer agreed but refused to pay the extra when the season was over. The court backed him on this decision.
	5. Mutual mistake. It’s one thing if one party makes a mistake but the other party didn’t (the contract is upheld as a way to incentivize more knowledgeable people). But if they both make the same mistake, the contract is thrown out. Contracts assume a “meeting of the minds” and when both parties make a mistake, the contract can be invalidated without worrying about poor incentives. Indeed, it encourages people to seek out important information.
		1. That one about the painter.
	6. Unexpected change of circumstance. While you can’t threaten to change a contract for no reason, you can get it invalidated if there was a change of circumstances that you couldn’t have anticipated. As mutual mistake, this ends an agreement that isn’t mutually beneficial without creating poor incentives.
		1. ???
	7. Unconscionable. In the past few decades, the court demonstrated it will throw out a contract if it sees the contract as simply unfair. This is one of the more conversional aspects of contract law: should the court be allowed to do this? Doesn’t “fairness” differ from person to person?
		1. In *Williams v. Walker-Thomas Furniture* (???), Williams bought several pieces of furniture from the defendant. The contracts for each piece stated that if she bought a piece before another piece is paid off, all pieces are treated as one collateral. Thus if she misses a payment on one piece, Walker-Thomas takes all the furniture she bought from them (even she had paid off those pieces). When she did just that, the court ruled this contract as unconscionable.
		2. Interestingly, Walker-Thomas operated in a poor neighborhood, where zero down payment, installment plans, and default would be common. Since furniture loses a lot of value immediately after being sold, repossessing on a piece-by-piece basis would result in a loss. “Cross-collateralization” combats this problem by treating paid-for items as collateral for to-be-paid-for items.
5. Negligence
	1. When a firm causes harm to its employees or customers due to negligence, should the firm be punished?
		1. All the time?
	2. Crafted by Judge Learned Hand in 1947, the Hand formula describes someone should be held responsible due to negligence if:

$$B<pL$$

* + 1. Where **B** is the burden of avoiding the accident,
		2. **p** is the probability the accident will occur, and
		3. **L** is the cost of the accident.
	1. So if there are no handrails (which are cheap to install) to prevent people from falling off a balcony (which is common and dangerous), the owner will be held liable.
	2. But if an owner didn’t clear the sidewalk of ice shortly after it formed (which is expensive to do) to prevent people from slipping (uncommon given the time constraint and not very harmful if it happens), the owner won’t be held liable.
		1. In *United States v. Carroll Towing Co.* (1947)
		2. In that one about the woman who saw the sun and tripped.
	3. The economic justification for the Hand formula is not just balancing expected costs (from the accident) to the certain costs (from the prevention) but also ensuring that the victim has taken due care. For some problems, it is cheaper for one party to prevent a problem than another party. This latter issue is called *contributory negligence*—when the victim of the accident is also negligent.