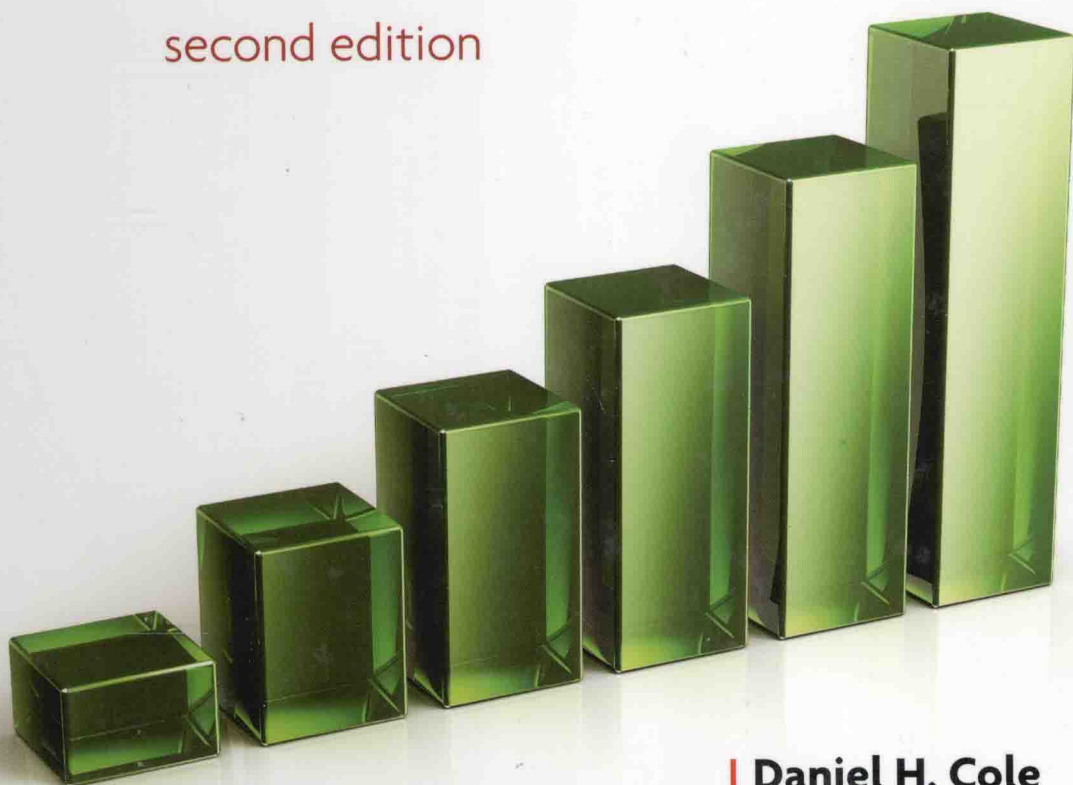


PRINCIPLES OF LAW & ECONOMICS

second edition



Daniel H. Cole
Peter Z. Grossman



Wolters Kluwer
Law & Business

Principles of Law and Economics

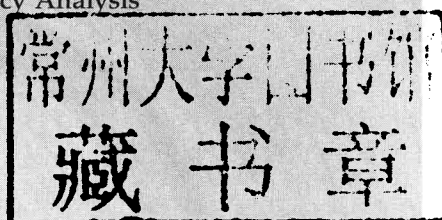
Second Edition

DANIEL H. COLE

Professor, Maurer School of Law
School of Public and Environmental Affairs
Workshop in Political Theory and Policy Analysis
Indiana University, Bloomington

PETER Z. GROSSMAN

Professor of Economics
Butler University



Wolters Kluwer
Law & Business

Copyright © 2011 CCH Incorporated.

Published by Wolters Kluwer Law & Business in New York.

Wolters Kluwer Law & Business serves customers worldwide with CCH, Aspen Publishers, and Kluwer Law International products. (www.wolterskluwerlb.com)

No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or utilized by any information storage or retrieval system, without written permission from the publisher. For information about permissions or to request permissions online, visit us at www.wolterskluwerlb.com, or a written request may be faxed to our permissions department at 212-771-0803.

To contact Customer Service, e-mail customer.service@wolterskluwer.com, call 1-800-234-1660, fax 1-800-901-9075, or mail correspondence to:

Wolters Kluwer Law & Business
Attn: Order Department
PO Box 990
Frederick, MD 21705

Printed in the United States of America.

1 2 3 4 5 6 7 8 9 0

ISBN 978-1-4548-0395-9

Library of Congress Cataloging-in-Publication Data

Cole, Daniel H., 1958-

Principles of law and economics / Daniel H. Cole, Peter Z. Grossman. — 2nd ed.
p. cm. — (Aspen college series)

Includes index.

ISBN-13: 978-1-4548-0395-9

ISBN-10: 1-4548-0395-9

1. Law—United States. 2. Law and economics. I. Grossman, Peter Z.,
1948- II. Title.
KF385.C65 2012
.349.73—dc23

2011024088

About Wolters Kluwer Law & Business

Wolters Kluwer Law & Business is a leading global provider of intelligent information and digital solutions for legal and business professionals in key specialty areas, and respected educational resources for professors and law students. Wolters Kluwer Law & Business connects legal and business professionals as well as those in the education market with timely, specialized authoritative content and information-enabled solutions to support success through productivity, accuracy and mobility.

Serving customers worldwide, Wolters Kluwer Law & Business products include those under the Aspen Publishers, CCH, Kluwer Law International, Loislaw, Best Case, ftwilliam.com and MediRegs family of products.

CCH products have been a trusted resource since 1913, and are highly regarded resources for legal, securities, antitrust and trade regulation, government contracting, banking, pension, payroll, employment and labor, and healthcare reimbursement and compliance professionals.

Aspen Publishers products provide essential information to attorneys, business professionals and law students. Written by preeminent authorities, the product line offers analytical and practical information in a range of specialty practice areas from securities law and intellectual property to mergers and acquisitions and pension/benefits. Aspen's trusted legal education resources provide professors and students with high-quality, up-to-date and effective resources for successful instruction and study in all areas of the law.

Kluwer Law International products provide the global business community with reliable international legal information in English. Legal practitioners, corporate counsel and business executives around the world rely on Kluwer Law journals, looseleafs, books, and electronic products for comprehensive information in many areas of international legal practice.

Loislaw is a comprehensive online legal research product providing legal content to law firm practitioners of various specializations. Loislaw provides attorneys with the ability to quickly and efficiently find the necessary legal information they need, when and where they need it, by facilitating access to primary law as well as state-specific law, records, forms and treatises.

Best Case Solutions is the leading bankruptcy software product to the bankruptcy industry. It provides software and workflow tools to flawlessly streamline petition preparation and the electronic filing process, while timely incorporating ever-changing court requirements.

ftwilliam.com offers employee benefits professionals the highest quality plan documents (retirement, welfare and non-qualified) and government forms (5500/PBGC, 1099 and IRS) software at highly competitive prices.

MediRegs products provide integrated health care compliance content and software solutions for professionals in healthcare, higher education and life sciences, including professionals in accounting, law and consulting.

Wolters Kluwer Law & Business, a division of Wolters Kluwer, is headquartered in New York. Wolters Kluwer is a market-leading global information services company focused on professionals.

Preface

To understand the law, and how the legal system works, students must have a basic understanding of economic principles. At the same time, the structure and performance of the economic system depend enormously on the legal rules. Law and economics are, thus, closely interrelated. This book's purpose is to describe and explain those interrelations.

For the past several years, we have been teaching Law and Economics together, to law students at the Indiana University School of Law at Indianapolis and to undergraduate economics students at Butler University. One of us is an economist, the other is a law professor. For years, we have been searching for a textbook that is neither too sophisticated, nor too sketchy, nor too simplistic for our students. We wanted a book basic enough to teach undergraduates *and* law students possessing limited (and in some cases nonexistent) backgrounds in economics, but sophisticated enough to be of use to graduate-level scholars. Finally, we gave up waiting and wrote one ourselves.

Although Law and Economics analysis has attained a high level of sophistication over the years, one does not need to be a graduate-level economist to understand its basic principles and applications. This book is designed for use by undergraduates, including those who have not yet taken an introductory economics course, as well as by law students with little or no previous economics training. With that target audience in mind, we have kept the mathematics to a minimum, presenting the analysis in language as clear and jargon-free as possible. The economic analysis is not simplistic, however. It may be sophisticated enough for many graduate-level economics students, but it is presented with sufficient explanations of concepts, principles, and arguments to enable novices to follow along without great difficulty.

Consistent with our commitment to relative novices in Law and Economics, the book begins with four chapters designed to ensure that all readers possess a basic understanding of fundamental economic principles (Chapter 1), the structure of the U.S. legal system (Chapter 2), and the importance of combining legal and economic analyses (Chapters 3 and 4). Readers with substantial knowledge of economics may choose to skip Chapter 1. Likewise, readers with a substantial experience in legal studies may choose to skip Chapter 2. Readers with substantial backgrounds in both law and economics may choose to begin with Chapter 3.

After the four introductory chapters, the book delves into traditional economic analyses of specific areas of law, including property (Chapters 5-7), contracts (Chapters 8-9), torts (Chapters 10-12), and crime (Chapter 13). Those common-law topics, dominated by judge-made law, are the centerpiece of most law and economics courses. It would be a mistake, however, to suppose that the law is nothing more than what common-law courts decide. The modern state is a regulatory state, in which laws made by legislatures and administrative bodies are at least as significant as court decisions. In recognition of the importance of regulatory law, this book also includes two chapters on the economic regulation of business. One concerns antitrust and regulated industries (Chapter 14); the other, environmental protection (Chapter 15).

Various approaches are utilized throughout the book, including conventional economic analysis (with and without descriptive figures), excerpts from fundamental works in the law and economics literature, statistical analyses, actual judicial decisions (as in law school “casebooks”), a bit of game theory, and even some history. We hope that this methodological variety, along with the question sets at the end of each chapter, enhances the reader’s utility and enjoyment.

Acknowledgments

This book has been four years in the making. In that time, we have benefited enormously from comments, criticisms, and suggestions provided by numerous readers, many of whom remain anonymous. Among those known to us are Kenny Crews, Robin Craig, Nicholas Georgakopoulos, Michael Heise, Shi-Ling Hsu, and Andy Klein. We are grateful to them, to the dozen or so anonymous reviewers, and to four classes of Law and Economics students—three at the Indiana University School of Law at Indianapolis and one at Butler University—who tested the book for us in various prepublication editions. Faith Long Knotts provided able administrative assistance. Last but not least, this book never would have seen the light of day without the support of our respective families. We dedicate the book to them.

Indianapolis
October 2003

DHC
PZG

Preface to the Second Edition

This new edition of *Principles of Law and Economics*—the first to be published by Wolters Kluwer Law & Business—is not greatly changed from the first edition. The organizational structure is the same, as is the book’s goal, which is to present the field of Law and Economics in a way that is neither too sophisticated for the novice nor too simplistic for more advanced students. We have worked in some new cases (and weeded out some old ones), increased the introduction and application of game theory, and added a bit to the brief discussion of intellectual property in Chapter 5. Aside from those substantive changes, we have tried to be responsive to issues raised by users of the first edition, our wonderful new editors at Wolters Kluwer, and several anonymous reviewers. We are grateful to all of them for their assistance. Dan Cole’s work on this new edition was generously supported by a summer research fellowship from the Indiana University School of Law–Indianapolis.

Daniel H. Cole & Peter Z. Grossman
Bloomington and Indianapolis,
June 2011

Acknowledgments

The authors are grateful to their respective families, as well as to many friends and colleagues who assisted us in preparing both editions of this book, including Kenny Crews, Robin Craig, Nicholas Georgakopoulos, Michael Heise, Shi-Ling Hsu, and Andy Klein, plus more than a dozen anonymous reviewers and several generations of students at the Indiana University School of Law–Indianapolis and Butler University. Faith Long provided stellar administrative assistance, as always.

The entire production team at Wolters Kluwer Aspen was tremendously helpful in getting this second edition to press. We are especially grateful to Carol McGeehan, Kaesmene Banks, and Sylvia Rebert for their assistance.

The authors sincerely appreciate permissions granted to reproduce the following materials:

Calabresi, Guido, and A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). Copyright © 1972 by the Harvard Law Review Association.

Demsetz, Harold, *Toward a Theory of Property Rights*, 57 AMER. ECON. REV. 347 (Pap. & Proc. 1967). Reprinted by permission of the American Economic Association.

Furubotn, Erik, and Rudolf Richter, *Institutions and Economic Theory: The Contribution of the New Institutional Economics* (2d ed. 2005). Reprinted by permission.

Hardin, Garrett, *The Tragedy of the Commons*, 121 SCI. 1243 (1968). Copyright © 1967 by the AAAS. Reprinted with permission of Science.

Llewellyn, Karl, *The Effect of Legal Institutions Upon Economics*, 15 AMER. ECON. REV. 664 (1924). Reprinted by permission of the American Economic Association.

Menell, Peter S., and Richard B. Stewart, *Environmental Law and Policy* (1994). Reprinted by permission.

Michelman, Frank, *Property, Utility, and Fairness: Comments on the Ethical Foundations of “Just Compensation” Law*, 80 HARV. L. REV. 1089 (1972). Copyright © 1972 by the Harvard Law Review Association.

Posner, Richard A., *Economic Analysis of Law* (7th ed. 2007). Reprinted by permission.

Reading Railroad, excerpt from contract of the Reading Railroad. Reprinted by permission of the Hagley Museum and Library.

Summary of Contents

<i>Contents</i>	<i>ix</i>
<i>Preface</i>	<i>xix</i>
<i>Preface to the Second Edition</i>	<i>xxi</i>
<i>Acknowledgments</i>	<i>xxiii</i>
 CHAPTER 1	
Economic Concepts and Institutions	1
 CHAPTER 2	
An Introduction to the American Legal System	31
 CHAPTER 3	
Putting Law and Economics Together: Frameworks, History, & Perspectives	53
 CHAPTER 4	
“The Problem of Social Cost” and Modern Law and Economics	87
 CHAPTER 5	
Property I: Acquisition	109
 CHAPTER 6	
Property II: Protection	139
 CHAPTER 7	
Property III: Limits	165
 CHAPTER 8	
Contracts I: Formation and Enforcement	197
 CHAPTER 9	
Contracts II: Remedies	229
 CHAPTER 10	
Torts I: Negligence	259

CHAPTER 11	
Torts II: Strict Liability	287
CHAPTER 12	
Torts III: Reform	309
CHAPTER 13	
Crime and Punishment	339
CHAPTER 14	
Antitrust and Regulated Industries	361
CHAPTER 15	
Environmental Protection	389
<i>Index</i>	427

Contents

<i>Preface</i>	<i>xix</i>
<i>Preface to the Second Edition</i>	<i>xxi</i>
<i>Acknowledgments</i>	<i>xxiii</i>

CHAPTER 1	
Economic Concepts and Institutions	1
A. What Economists Study	1
B. Incentives Matter	1
C. Resource Scarcity	2
D. Cost and Price	4
E. Economic Decisions Are Made at the Margins	5
F. Allocating Entitlements to Resources	6
G. Supply, Demand, and the Market	6
1. The Law of Demand	6
2. The Law of Supply	9
3. The Market: Where Buyers and Sellers Meet	10
4. Market Equilibrium: Where Supply Meets Demand	11
H. Efficiency	12
1. Productive, Allocative, and Adaptive Efficiency	13
2. Measuring Allocative Efficiency: The Pareto and Kaldor-Hicks Criteria	13
3. Cost-Benefit Analysis	16
I. Market Failure	16
1. Neoclassical Assumptions versus the Real World	16
2. Imperfect Competition	17
3. Imperfect or Asymmetric Information	18
4. Externalities	18
5. Public Goods	20

6. Transaction Costs	21
7. Strategic Behavior: Free-Riders and Holdouts (and an Introduction to Game Theory)	21
J. Responses to Market Failure: Firms and Governments (and Their Failures)	27
1. Firms	27
2. Government Intervention to Correct Market and Firm Failures	27
3. Government Failure	28
K. The Second-Best (<i>Real</i> Coasean) World	28
L. Chapter Summary	29
M. Questions and Problems	29

CHAPTER 2

An Introduction to the American Legal System	31
A. Why Law?	31
1. Scarcity Again	31
2. The Purposes of Law	32
B. Legal Institutions: “The Rules of the Game”	32
1. Legal Rules	32
2. The Rule of Law	33
3. Criminal and Civil Law	34
4. Rights and Duties	35
5. Liability and Remedy	35
C. Sources and Areas of Law	36
1. Constitutional Law	36
2. The Common Law and Its Courts	37
3. Statutory Law	38
4. Administrative Law	40
5. A Note on Local Custom: How Neighbors Settle Disputes	40
D. The Organization of American Legal Decision Making	41
1. The State Court Systems	41
2. The Federal Courts of the United States	46
3. State and Federal Legislative and Regulatory Bodies and Processes	49
E. Chapter Summary	52
F. Questions and Problems	52

CHAPTER 3

**Putting Law and Economics Together:
Frameworks, History, & Perspectives** 53

A. Economic and Legal Frameworks	53
1. What Economic Analysis Has to Offer Legislators, Judges, and Legal Scholars	54
2. Limitations of the Economic Approach to Law	61
3. The Legal Structure of Economic Activity	63
B. An Outline History of Law and Economics	67
1. Progressive Era Law and Economics	67
2. The Coasean Revolution	68
3. Modern Law and Economics	70
C. Perspectives on Law and Economics	71
1. The Chicago School—Neoclassical Law and Economics	72
2. Public Choice	73
3. Institutional Law and Economics	75
4. New Institutional Economics	78
5. Behavioral Law and Economics	81
D. Chapter Summary	84
E. Questions and Problems	85

CHAPTER 4

**“The Problem of Social Cost” and Modern Law
and Economics** 87

A. The Nature of Social-Cost Problems: Coase v. Pigou	87
B. The “Coase Theorem”	90
1. No Problems of Social Cost Would Arise in a World of Perfect Competition, Complete Information, and Costless Transacting (<i>i.e.</i> , the World of Neoclassical Economic Theory)	90
2. Critiques of the Coase Theorem	95
C. Transaction Costs and Law in the Real World	96
D. The Courts and the “Delimitation” of Entitlements	102
E. “The Problem of Social Cost” and Modern Law and Economics	103
F. Chapter Summary	106
G. Questions and Problems	106

CHAPTER 5

Property I: Acquisition **109**

A. What Is Property?	109
1. Rights and Duties Respecting Things	109
2. Not One Right, But a “Bundle of Rights”	109
3. What Makes a Right “Property”?	110
4. “Ownership” and Relativity of Title	110
B. Types of Property Regimes	113
1. Res Privatae	114
2. Res Publicae	114
3. Res Communes	114
4. Res Nullius	114
5. Mixed-Property Regimes	115
6. Property Regime Choice	115
C. Economic Functions of Property	116
1. Economic Exchange, Development, and Growth	116
2. Resource Conservation	118
3. Anticompetitive Effects of Monopoly Property Rights: Incentives to Innovate vs. Market Competition in Intellectual Property Law	124
D. Sources of Property	128
1. Bottom-Up Theories of Property: Prepolitical or Natural Property Rights	128
2. Top-Down: Political Definition and Allocation of Property	130
E. Allocating Property Rights	131
1. Allocation Mechanisms	131
2. Allocation “Institutions”	134
F. Chapter Summary	137
G. Questions and Problems	137

CHAPTER 6

Property II: Protection **139**

A. Determining Liability	140
1. Strict Liability—Trespass and Nuisance Distinguished	140
2. Modern Nuisance Law	141
B. The Remedy Decision	144
1. Types of Remedies	145

2. Property Rules—Injunctive Relief	151
3. Liability Rules—Money Damages	153
4. Hybrid Property/Liability Rules	156
5. Inalienability Rules	161
C. Chapter Summary	164
D. Questions and Problems	164

CHAPTER 7

Property III: Limits	165
A. Private Law Limitations	165
1. Nuisance Law as a Limitation on Property	165
2. Private Land-Use Planning—Covenants	169
B. Public-Law Limitations on Private Property	171
1. Police-Power Regulation	172
C. Constitutional Limitations on Public Regulation of Private Property: Regulatory Takings Law	183
1. Justifications for Regulatory Takings Law in the Law and Economics Literature	190
D. Chapter Summary	195
E. Questions and Problems	195

CHAPTER 8

Contracts I: Formation and Enforcement	197
A. The Basics of Contract Law	197
1. The Nature of a Contract	197
2. Caveat: Not All Promises Constitute Contracts	199
3. Enforcement	201
4. Should Contracts Always Be Enforced?	204
B. Contract Failure	205
1. Two Economic Views of Contract Failure and the Role of Courts	206
C. Reasons for Contract Breach	212
1. Formation Defenses	212
2. Performance Excuses	222
D. Chapter Summary	226
E. Questions and Problems	226

CHAPTER 9

Contracts II: Remedies 229

A. Types of Remedy for Contract Breach	229
1. Specific Performance	229
2. Money Damages	234
B. The Notion of Efficient Breach	234
C. The Costs of Reliance and Precaution	244
1. Efficient Reliance	244
2. Efficient Precaution	245
D. Alternative Approaches to Calculating Damages	246
1. Expectation Damages	246
2. Reliance Damages	249
3. Restitution	253
4. Liquidated Damages/Penalty Clauses	255
E. Chapter Summary	256
F. Questions and Problems	257

CHAPTER 10

Torts I: Negligence 259

A. Prologue: Accidents Happen	259
B. What Is a Tort?	260
1. Civil Wrongs	260
2. The Common Law of Torts	260
3. Types of Torts	263
4. An Economic Approach to Torts	265
C. Legal and Economic Functions of Tort Law	269
1. Corrective Justice	269
2. Deterrence Through Internalization of Externalities	270
3. Punishment	270
4. Maximizing Social Welfare by Minimizing the Total Costs of Torts	272
D. The Law and Economics of Negligence	273
1. Simple Negligence: Creating Incentives for Reasonable (<i>i.e.</i> , Efficient) Behavior by Tort Defendants	273
2. Influencing Plaintiffs' Incentives: Defenses to Negligence	276
E. The Role of Insurance in Negligence Law	283
F. Chapter Summary	286
G. Questions and Problems	286

CHAPTER 11

Torts II: Strict Liability 287

A. An Alternative to Negligence	287
1. The Elements of Strict Liability	288
2. Why Strict Liability?	289
3. Defenses to Strict Liability	295
B. Strict Liability v. Negligence	298
1. Historical Context of the Debate	298
2. The Comparative Ethics of Negligence and Strict Liability	300
3. Comparative Institutional Analysis	300
C. The Costs of Administering the Torts System	304
1. Choosing the Legal Rule	304
2. The Costs of Estimating Damages	305
3. The Costs of Evaluating <i>Ex Ante</i> Precautions and Potential Precautions	306
D. Chapter Summary	307
E. Questions and Problems	307

CHAPTER 12

Torts III: Reform 309

A. The Case for Tort Reform	309
1. The Current Tort System Produces Net Social Costs	309
2. Tort Reform Recommendations	312
B. The Case Against Tort Reform	313
1. Fact, Fiction, and the Tort System	313
2. Are Tort Reform Cures Worse Than the Disease?	319
C. Experiences in Tort Reform	322
1. Caps on Punitive Damages	322
2. Limitations on Joint and Several Liability	327
3. Ceilings on Malpractice Liability	327
4. Collateral Source Rules	327
5. Federal Tort Reforms	328
D. Economic Consequences of Tort Reform	328
E. The “No Fault” Alternative	331
1. Workers’ Compensation and “No Fault” Auto Insurance in the United States	331
2. Comprehensive “No Fault” Insurance in New Zealand	333