LAW AND ECONOMICS

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LAW AND ECONOMICS

Week 5

Contract law – Basic topics

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Structure of the week

I. What is a contract? – Why is there a contract?
II. Freedom of contract
III. Economic requirements
   I. (Neo)classical
   II. Non classical
IV. Mandatory vs. default rules

I. What is a contract?

- Contract = legally enforceable promise
- What is enforcement?
  - Continental: *pacta sunt servanda* (contract must be performed) – specific performance.
  - Common law: remedies – promise to perform OR to compensate the other party for the loss caused by (non-performance of) the promise.

I. Why is there a contract?

1. *Commitment – trust game*
2. *Coordination*
3. *Compensation*

I.1. Commitment
Trust game

- Revision: contract shifts the equilibrium from no investment to cooperation.

- *Ex ante: mutually beneficial!*
- *Ex post: breach would be personal optimum – enforcement is worse for potential breaching party.*
- Time-inconsistency.
  - Ex ante vs. ex post incentives
  - *Ex ante* contract is good for constructor as well – without contract payoff would be zero.

I.2. Coordination

- Stag hunt (*J.-J. Rousseau*) Two hunters; alternatives: deer (success only if both go for it) or rabbit (smaller payoff but individually).
  Simultaneous choice

	Rabbit	**Deer**
Rabbit	1,1	1,0
Deer	0,1	2,2

- Coordination problem: two Nash-equilibria; deer-deer is Pareto-superior.
- Contract? Information: hunting for deer?
- Commitment: if rabbit, punishment? – E.g. if punishment is higher than rabbit-value, then rabbit payoff is negative.
  - ***BUT not necessary – no time-inconsistency…***

I.3. Compensation

Example: freight insurance. Shipping contract – insurance for the cargo? By whom?
For both parties

1. …best outcome (payoff: 4) if there is insurance by the other party; worst outcome (payoff 0) if no insurance.
2. …it is better to buy insurance himself rather than not have it at all.
   – The carrier may buy insurance at less cost (his payoff in case of one-sided insurance is higher than the other party's would be)

	Without contract					With contract		
		Customer					Customer	
Carrier		Buy	No		Carrier		Buy	No
	Buy	1; 1	3; 4			Buy	1; 1	4,2; 2,8
	No	4; 2	0; 0			No	4; 2	0; 0

Two Nash-equilibria. Neither is Pareto-superior!
But sum is lowest if only carrier buys insurance.
New problem: the promisor (carrier) has no *ex ante* incentive to make the promise – need for compensation.

- E.g. higher price => extra 1,2 units from customer to carrier: Pareto-superior change.

II. Freedom of contract

Economic theory:

- *Coase theorem:* bargaining is efficient – should not be constrained.
- *Transaction cost must be reduced –*
  - *Make bargaining easier.*

Revision: Coase theorem

- Freedom of contract: parties will make efficient decisions; all opportunities of mutually beneficial cooperation will be exploited.
- IF transaction cost is zero!
- *Greater freedom of contract = lower transaction costs.*

Revision: Transaction costs and their reduction *– role of courts, companies, default rules*

- *Williamson's model*
  - High idiosyncrasy
  - Incomplete contract.
  - Threat of opportunism.
- *Forms of contract* (Williamson *from* Macneil [1974])

III. Economic requirements

1. *(Neo)classical*
   Cooter–Ulen
   Craswell, Posner

2. *Non classical (unorthodox) economics*

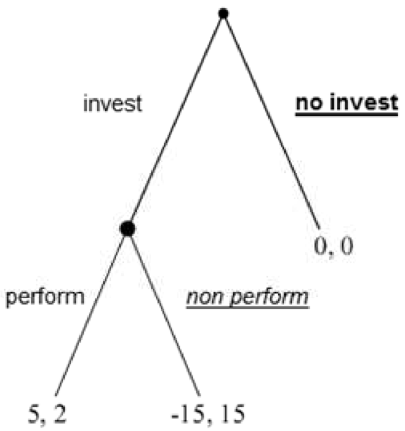
III.1. (Neo)classical requiremets

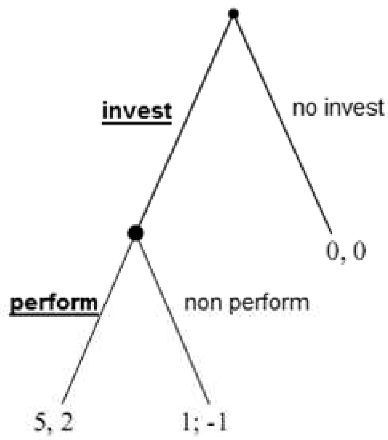
Incentive effects of contract law:

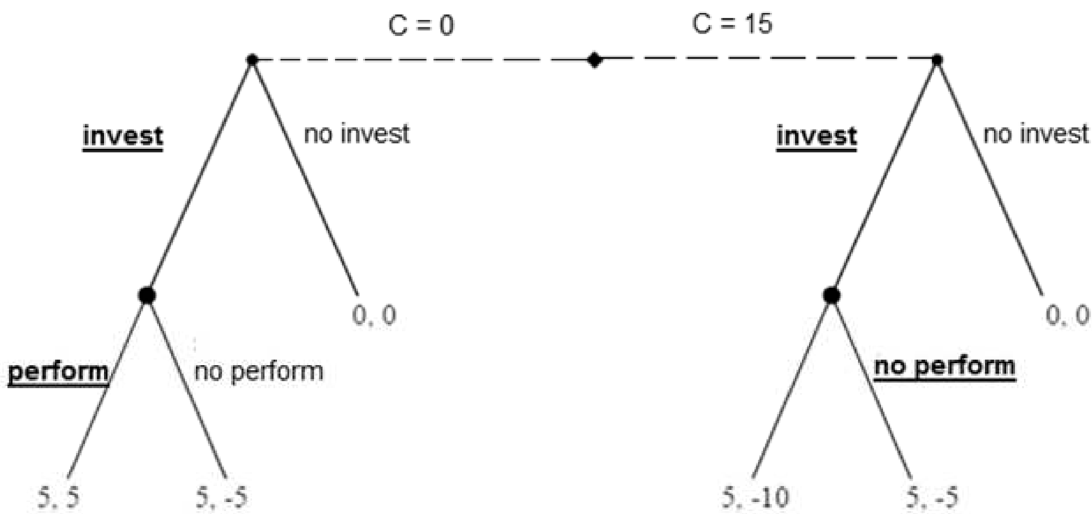
1. How much information to be gathered and shared?
2. How long to search for partners, when to stop and make a contract?
3. How precise should the contract be?
4. How to allocate the risk?
5. To perform or to breach?
6. How much care to take – how to reduce the risk of problems constraining performance?
7. How much specific investment to make (reliance)?
8. How to mitigate the loss (after breach)?
9. What to do if unexpected, unregulated problems occur – readiness to modify the contract?

- Focus on (5): to perform or to breach?
- Efficient breach…
  - When?
    - Cost of performance > expected benefit from performance (for the promisee)
  - Private incentive (promisor):
    - Cost of performance > compensation paid upon breach (remedy)
  - Private optimum = social optimum, IF
    - expected benefit from performance (for the promisee)
      = remedy.

Trust game, no contract *Trust game, contract*







III.2. Non classical (unorthodox) economics

- *Bounded rationality?* – Information problems + even if full information, cognitive problems
  - Clear and coherent preferences? Decisions based on rational calculation?

- *Paternalism?* – contract based on two people's free will (and full information) = their best interests?
  - *Perfectionism, communitarianism*: what is *really* good for them (false preferences do not lead to real goods for man) vs. bounded rationality (no rational calculation based on the preferences)
  - E.g. it is *not good* to discount the future heavily (value present pleasure more than log term health)

IV. Tools in contract law: mandatory and default rules

- Two basic tools? Mandatory and default rules
- Mandatory: what is allowed in a contract
  - If violated, no enforcement in court,
  - Or perhaps fight against such contracts (and punishment) – e.g. commerce with prohibited products
- Default: the parties may contract with other terms
  - Appropriate default rule = reduction in transaction costs (no need to bargain or contract for it),
  - Enlarge freedom of contract.

IV.1. Efficient default rules

Majority default rule: no need to contract about every issue; simplifies transaction

- Contracting if fear that inefficient rule is applied in the absence of precise expression in contract
- Rule for which no contracting out is necessary – for the majority of contracts

- How do we know what would have been the agreement without the default rule?
- Risk-bearer test: risk on the party who
  - Learns the risk more easily (cheaply).
  - Reduces the risk more easily (cheaply) – e.g. is able to prevent the problem.
  - Is less risk averse: able to insure himself at lower cost.
    - Market insurance: buy insurance policy at a lower price.
    - Self-insurance – e.g. in case of large and diversified assets: almost risk-neutral agent, NO need to buy policy: insurance fee would be higher than expected loss

- *Penalty default rule*: disadvantage for one of the parties (typically: party with more information).
  - Contracting out reveals private information
  - E.g. *Hadley-rule*: if the loss of victim is higher than expected (average) but the victim knew it ex ante, then no compensation for the loss above average => victim could contract for a higher remedy (at a higher price), but the promisor will then learn the higher value of the contract.

IV.2. Mandatory rules

Prohibition or obligation

Prohibit contracts with certain terms

Oblige to sign a contract (e.g. mandatory public service: waste management, chimney, universal service provision).

Substantive vs. procedural

Substantive – e.g. minimum wage, product safety, mandatory guarantee.

Procedural: no constraint on the terms, but requirements for actions before contracting and during the relationship

- Default rules are based on procedural mandatory rules

Standards vs. rules

Standards – general clauses (in continental law): define the goal (e.g. immoral contracts are not enforced); no exact list of prohibited terms – it is the court's task to decide

Rules: exact list of the prohibited (unenforceable) terms => predictable but easy to create contract around

- Reduce the power of courts vs. corruption in legislation.

IV.2. Mandatory rules: when?

a) Third party effects
b) Information asymmetry
c) Bounded rationality

IV.3. Mandatory vs. default times – unclear boundaries

- Sticky default rules
  - The will to contract out is hard to express explicitly, i.e. make it clear for the court (e.g. if ex post debate between the parties about the exact meaning, court will not see clearly and judge opts for the default rule).
  - *Status quo effect*: the parties do not want to contract out – because it provides information about themselves.
- It may not be clear if a given rule is mandatory or default.

IV.4. Mandatory rules: public or private enforcement?

- *Public enforcement:* victim decides whether to sue
  - Cost of legal process (direct cost – fees; time; chances of winning)
- *Public enforcement:* no need for action by victims – public administration tries to enforce the rule or take the case to court.
  - Cost of administration (police, SEF, etc.)

Practice

Why contract?

Commitment – trust game
Coordination
Compensation

Example: labour contract

Why accept a deferred wage?

- Deferred wage = now (short term): wage is below productivity (marginal value of production); future: above productivity.
- On average (lifelong wage), equal to productivity
- BUT:
- What if employee is fired when wage rises above productivity?

Labour contract – solution

Non-legal enforcement…

Morality? Trust in employer?
Repeated game?
Reputation? Others will not accept a similar offer by the employer?
Bonding? Employer makes specific investment in employees – lost in case of exit?

Discussion

- Why more organ transplants (and donors) in Hungary than in Denmark?
  - In Denmark: default rule is ‘no’ – if someone wants to be a donor, he must register himself.
  - In Hungary: default rule is ‘yes’ – if someone does not want to be donor, he must register himself.
- Why more exit from private pension system in 2011, when the default rule was exit (and registration for stay), than one year earlier when the default rule was staying (registration for exit)?

Revision

- Mandatory vs. default rule
- What is a default rule?
  - Majority default rules?
  - Penalty default rules?
  - Why sticky? Example?

- What is a mandatory rule?
  - Differences between substantive and procedural rules?
  - Differences, pros and cons: standards vs. rules?

Requirements

Incentives: what do they mean?

1. *information*
2. *search*
3. *precision*
4. *risk allocation*
5. *performance*
6. *care*
7. *reliance*
8. *mitigation*
9. *modification*

Revision

- What is efficient breach?
- What is rent-seeking?
  - Rent (= economic profit)?
  - Rent-seeking in a market? In politics?
  - Connection between intellectual property and rent?
  - What is wrong with political (non-market) rent-seeking?
    - Resources used for pure redistribution (no production)