Constitution 1, 9411191 <Summary of Chapter I & 9> Kim, Sung Eun
Chapter 1: The Power of Incentives

Most of economics can be summarized into four words of 'people respond to incentives'. Almost everyone will admit its validity as a general principle. There is evidence that people respond significantly to incentives even in situations where we do not usually imagine their behavior to be rational. The response to incentives may be as innate as any other instinctive behavior. Incentives matter, and numerous economic publications of empirical studies verify this proposition, and economists are forever expanding the domain of its applicability. Examples of shoppers responding to the price of gas, drivers responding to seat belts, murderers responding to the death penalty, and rats and pigeons responding to wage, income, and price changes just like humans show that thorough all the variations, one theme recurs: Incentives matter.

Chapter 9: Of Medicine and Candy, Trains and Sparks

In the example of Sturges and Bridgman, we could say that the court's decision has no effect on the eventual outcome. To be more precise, we would say that while the judges' decision does matter to Sturges and Bridgman, it does not matter to anyone else. The decision does not affect the overall allocation of resources. That is, it does not affect what gets produced, or the means of production. The conflict between Sturges and Bridgman is a conflict over who should control a resource. The court can grant control of this resource to either party and can protect that grant in a variety of ways, but whoever controls the resource, and however it is protected, he will find it to his private advantage to direct the resource to its most profitable use, regardless of whether that use is by him or by his neighbor. The court cannot affect the profitability of either enterprise and therefore cannot control how the resource is employed. This observation about the impotence of judges was made in 1961 by Professor Ronald Coase of the University of Chicago Law School. It has come as a revelation to economists, jurists, and legal scholars once it was stated and also marked the birth of a new academic specialty: the economic analysis of law. The Coase Theorem applies whenever the parties to a dispute are able to negotiate, to strike bargains, and to be confident that their bargains are enforceable. The Coase Theorem states that the allocation of property rights, or the choice of liability rules, or more generally any distribution of entitlements has no effect on the ultimate allocation of resources, which means the judges' decision do not matter. However, it is possible to think circumstances in which the Coase Theorem does not apply, because negotiations are either impossible or prohibitively expensive. This can happen if the number of parties to a dispute is very large. In the flip side of the Coase Theorem, when circumstances prevent negotiations, entitlements - liability rules, property rights, and so forth - do matter. Moreover, the traditional economist's prescription for efficiency - making each individual fully responsible for the costs he imposes on others is meaningless. It is meaningless because the costs in question result from conflicts between two activities, not from activity in isolation. The traditional prescription blinds us to the fact that either party to a conflict might be in possession of the efficient solution, and that the wrong liability rule can eliminate the incentive to implement that solution. Some factories pollute the air, damaging the health and happiness of the area residents. If the residents are allowed to sue for these damages, the residents have no incentive to adopt measure like pollution-resistant house paints, or to move away. If the residents are not allowed to sue, the factory has no incentive to switch to cleaner fuels, or to install pollution control equipment, or to reduce its output, or to move. Any of these solutions can be the most efficient. Economic theory does not reveal whether it is cheaper for the factory to control its emissions or for the residents to move. The court's decision matters, and the efficient decision depends on the particulars of the case. What the court attempts to do depends on what the judges are trying to accomplish. If their goal is something other then economic efficiency such as justice, fairness, or some abstract legal criterion, economic analysis has relatively to contribute. But if the goal is economic efficiency, then there is much to be learned from Coase's analysis and the body of knowledge that has grown form it. Judges often express explicit interest in the economic consequences of their actions, and economists believe that such considerations have played a major role in the

evolution of the common law. For the judges who share these concerns, we can advise them the following:

First, a note of reassurance: If you are trying a case where the opposing parties are able to negotiate and enforce contracts, then your decision does not matter and you cannot be wrong. Subsequent negotiations will lead to an efficient allocation of resources that is entirely independent of what you decide. Second, a note of caution: Do not attempt to decide a case by deciding who is at fault. The costs of damage should be borne by the party, who can prevent the damage more cheaply, not necessarily by the one whom would be labeled the 'perpetrator' by misguided common sense. Third, a note of condolence: It might be very difficult for you to tell who can prevent the damage more cheaply. Unless you are an expert on the according fields, you are unlikely to know where to place the burden. Fourth, a suggestion: try to make it easier for the parties to negotiate where we can go back to the situation where you can never be wrong. The moral of the example of the coal miners is to let the miners bear the costs of the accidents, so that every cost-justified means of preventing accidents can be adopted. The greater moral is that judges should assign liability in such a way to maximize the opportunities for post-trial negotiations. Because judges are not omniscient, they should make rulings that can be easily reversed through bargaining among the participants. It is the participants, after all, who know the most about the costs and consequences of their own actions. The moral of the AIDS example is that each liability rule is flawed in its own way and the court, without the luxury of endless philosophizing about pros and cons, must select one or the other. Coase or any economist cannot know what the right decision is, and nothing in economics can decide this case. But what Coase brought to discussion was an entirely new way of balancing the issues. The suggestion here is that the court should not even attempt to estimate such costs and benefits. Instead, they are best revealed through the negotiations between the involved parties. The right question for the court to consider is: Which liability rule is least likely to interfere with these negotiations? We might not always know the answer, but finding the right questions is a big step towards progress.