I. Summary: efficiency

We have seen that sometimes lawyers try to design rules and institutions in such a way that people can achieve mutually beneficial outcomes by transacting with one another. Such transactions are Pareto-improving if they make at least one person better off and make no one worse off. (We noticed problems for the concepts of “better off” and “worse off.”) But many rules and institutions, and many transactions (those causing negative externalities), make some people better off at the price of making some worse off. Such rules, institutions, and transactions achieve Kaldor-Hicks efficiency when they generate the greatest sum of benefits net of costs. The idea is to continue generating additional social value (social surplus), so long as each incremental gain more than makes up for associated losses. (Though the principle of Kaldor-Hicks efficiency does not require the gainers to compensate the losers, other principles might. Such principles speak to compensation and distribution. Efficiency, by contrast, is not about the distribution of gains and losses but about “growing the pie” – maximizing the gains net of losses.)

II. Barriers to mutually beneficial transactions

In our reading for class #14, we saw that sometimes, as in the used car market, potentially mutually beneficial transactions don’t take place. (Alice would gain from selling her old car to Bob, and Bob would gain by buying it. But they don’t transact; Alice never puts her car on the market. This is illustrates adverse selection.) Or a transaction does take place (the insurance contract), but entering into the contract creates perverse incentives that make at least one party, and perhaps both parties, worse off than necessary. This is moral hazard. And in the employment context (and related areas), such perverse incentives create principal/agent problems. Our reading notices a common thread in these barriers to mutual benefit: one side has information that the other side lacks. (This is called “asymmetrical information.”) (The readings for class #17, on collective action problems, free riding, and the prisoner’s dilemma, also relate to this underlying problem.)

III. Obtaining the information needed for mutually beneficial transactions

The difficulty of obtaining accurate information is a “transaction cost.” Markets can supply some of the needed information (e.g., Consumer Reports information about product quality), but sometimes law steps in (nutritional labeling, automobile gas mileage information, title recordation in property law) to make information more readily available. Our question is: how can lawyers, by drafting and negotiating contract terms and by shaping legal policy, overcome the information problems that frustrate attainment of mutually beneficial outcomes?
IV. **Moral Hazard** (pp. 241-245)

A moral hazard is created when entering into a contract changes the incentives of one or more parties in a way that works to the disadvantage of one or more parties. (The label is misleading, since the idea presupposes no “moral” assumptions other than the efficiency norm.) Example: buying fire insurance reduces my incentives to install smoke detectors and clear brush from around my house. This may cause the cost of insurance to be higher than it would be if we took the precautions we would have taken in the absence of insurance. Gathering information can relieve the moral hazard problem, as when the insurance company inspects the home for smoke detectors, brush clearance, etc.

V. **Adverse Selection** (pp. 245-247)

Adverse selection, like moral hazard, is a problem created by asymmetrical information (one side has information that the other lacks). Adverse selection occurs in a market when one side lacks information and thus sets prices based on averages – thus inducing those who are above average to leave the market. Example: the perception that individuals selectively put less reliable used cars on the market while holding on to more reliable cars causes used car prices to be low, which in turn discourages individuals from putting their highly reliable used car on the market. (This is an example of a positive feedback loop, such as that involved in global warming. Higher temperatures cause the ice caps to melt, which in turn reduces reflection of sunlight into the atmosphere, which in turn increases temperatures.)

Mandatory insurance, such as the health insurance mandates in the Affordable Health Care Act (p. 253), offer one way to relieve adverse selection problems, but such mandates can be difficult to enforce.

VI. **The Principal-Agent Problem** (pp. 247-248 [top of page])

A Principal-agent problem arises when the individual or firm (the principal) purchasing another’s services lacks full information and thus does not know how well the one whose services are purchased (the agent) is performing the purchased service. This is another instance of asymmetrical information. (Pages 248-251, not assigned, explain how the design of employment contracts can reduce principal-agent problems that arise in one important area of market relationships: the employment relationship.)

But principal-agent problems also make it difficult to design voluntary associations and public institutions such as a well-functioning system of representative democracy. Recall that some versions of intentionalism in statutory interpretation (see pp. 27-29) are meant to constrain judges so that they act as better, more faithful “agents” of the legislature. But it is difficult for the legislative “principal” to monitor and control the judicial “agent.” (Whether the judicial role should be understood in principal-agent terms is itself controversial. Ideals of judicial independence, and devices such as life tenure of Article III federal judges, might suggest that the principal-agent relationship is not the only way to think about the relationship between legislatures and courts.)