A Public Choice Analysis of the Evolution of Tort Law:

A Comment

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ABSTRACT. In contrast to the article by *W. Harris,* it is contended that in the area of *product liability* a rule of *strict liability* is not necessarily less efficient than a *negligence* rule and an analogy between product liability cases and *lotteries* is not appropriate.

I

Introduction

THE RECENT ARTICLE in this *Journal* by William T. Harris[1] made the argument that, (1) current liability rules for allocating losses in personal injury cases are inefficient, and (2) this inefficiency can be explained in large part by the desire of rational individuals to participate in lotteries. The latter conclusion is based on two claims: first, that personal injury litigation, as it exists, resembles a lottery with a few individuals receiving large payoffs, and second, that the area of tort law that governs product-related accidents (products liability law), where strict liability is the rule, took shape roughly at the same time that state lotteries were first introduced.[2] Under strict products liability, once a product defect has been determined to be the cause of an accident, the victim is entitled to compensation regardless of the care taken by the manufacturer in producing the product. Thus, unlike negligence law, injurer "fault" is not necessary for recovery. The premise of the article's contention is that fault-based rules are more efficient than is strict liability in the area of product accidents.

The purpose of this comment is twofold: first, to suggest that, at least in the area of products liability, a rule of strict liability for product defects is not necessarily less efficient than a negligence rule,[3] and second, to argue that Harris's analogy between product liability cases and lotteries is inappropriate.

II

The Efficiency of Strict Product Liability

IN ARGUING for the use of negligence over strict liability in product related accidents, Harris identifies two factors that tend to favor a negligence rule. The

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first is the inefficiency of "forcing" insurance (through strict liability) on consumers who do not want coverage. The second is the higher transaction costs associated with strict liability due to increased litigation. While these two factors in isolation can favor a negligence approach, Harris ignores a number of other factors that favor strict liability in the context of product related accidents. These include the impact of the liability rule on total output or production of dangerous products, consumer misperceptions, damages to bystanders, and transaction costs per case.

Suppose manufacturers are held liable only for damages caused by their negligence, and negligence is defined (as usual) in terms of the manufacturer's care. Then the manufacturer will be induced to take efficient care. Care, however, is not the only determinant of the expected costs of product accidents; the number of units produced and sold is also important. In particular, as more units of a good are sold, the expected number of accidents increases. Thus, minimization of accident costs also requires that manufacturers produce the optimal level of output. Manufacturers would choose optimal output if all accident costs are borne by consumers and the latter accurately perceived the risk of the product. In this case, reduced demand by consumers (in response to the increased risk) leads to lower output levels. (After all, it takes a buyer and a seller to make a sale). However, consumers are almost certainly less knowledgeable about product risks than manufacturers are, so they will generally not make the correct adjustment. For example, if they underestimate risks, they will purchase too much of the product.[4] Likewise, if some product related accident costs are borne by "bystanders" who cannot translate increased risk into reduced demand, then the correct adjustment will not occur. For both of these reasons, manufacturers may produce too much under a negligence rule. A strict liability rule, on the other hand, leads to the efficient level of output, even with consumer misperceptions and damages to bystanders, because the manufacturer fully (and accurately) internalizes all costs of production, including accident costs, and conveys this information to consumers through the price.[5]

It follows from this argument that there is a trade-off between strict liability and negligence. Negligence induces efficient care by victims but generally inefficient output by producers, and strict liability induces efficient output by producers but inefficient care by victims. Consequently, if output is a more important determinant of product accidents than victim care, strict liability may be allocatively superior. For many types of products, this would seem to be the case.

Harris also argues that negligence is preferred on the basis of transaction costs. While strict liability may result in more litigation, once a suit has been filed the transaction costs per suit tend to be higher under negligence since the plaintiff must establish the defendant's fault. In addition, a negligence rule can

lead to "errors" when courts have difficulty in defining or in determining compliance with the due standard of care. Consider, for example, research to improve the safety of the product. Under strict liability, the court does not have to determine whether the manufacturer conducted an appropriate amount of research prior to marketing the product. Because producers bear the cost of product accidents, they have an incentive to conduct any cost-effective research and development in an effort to reduce their liability burden. In principle, a negligence rule can also induce efficient investment in product research because, as noted above, a safer product translates into greater consumer demand (absent misperceptions). However, determination of liability would be much costlier in this context because courts would have to inquire about what information the manufacturer actually had when it sold the product compared to what it should have had. This greatly increases the transaction costs per case under negligence compared to strict liability.[6] The overall effect on transaction costs is therefore ambiguous: strict liability leads to more cases compared to negligence, but negligence leads to higher costs per case.[7]

Finally, part of Harris's argument against strict liability is that it functions as a form of involuntary insurance for consumers, given that the product price includes an implicit insurance premium paid by all buyers who can subsequently seek recovery through the legal system (at great expense) in the event of an accident. Harris suggests that, given the choice, some consumers would prefer to pay a lower price and self-insure. There are two problems with this option. First, it again requires that consumers correctly perceive the risks of product accidents in order to make the proper decision. Second, as noted above, many victims of product accidents are not the original purchaser of the product. These victims clearly would not be better off with a lower price (the benefits of which they do not receive) in exchange for a waiver of producer liability.[8]

III

Product Liability Law as a Voluntary Lottery

HARRIS'S SECOND major point is that current product liability law can be understood as a lottery similar to those that have been established by numerous state legislatures. In support of his position, he argues that the timing of development of product liability law coincides with the introduction of state lotteries, and that their pay-out rates are very similar. We question the accuracy of the first argument and the relevance of the second.

With regard to the timing, the trend toward producer liability for product accidents occurred gradually throughout the twentieth century,[9] primarily by judicial decision, and a precedent for strict liability for product defects was set

as early as 1944.[10] Thus, the legislative adoption of strict liability by many states in the 1960s did not mark an abrupt change in the law; it had been evolving in that direction for several decades. In addition, several states are now seeking to restrict producer liability for product related accidents.[11] No similar legislative changes for state lotteries appear to be under consideration. Thus, any perceived "co-evolution" over time seems to be at best weak and more likely non-existent.

Even if the two institutions did develop simultaneously, this does not establish a link between them. There is no reason to believe that the two stem from the same underlying public preference. (Any correlation could be purely spurious.) In fact, the two institutions appear to be fundamentally different. A consumer who has purchased a lottery ticket always wants to win. For a small cost (say $1), there is potentially a large pay-out. In the case of product liability, the cost is not necessarily small. In addition to the increased product price, an individual must bear a potentially very large cost in the form of damages. In other words, unlike state lotteries, product liability pay-outs are contingent upon damages occurring. It is not the entire population of purchasers of the product who are eligible for the pay-out, but only those who suffer damages from the product. We find it hard to believe that consumers who purchase a product hope to be injured so that they are eligible for the "big win." In fact, given the risk of receiving nothing in compensation for their damages, or receiving an amount less than the full amount of damages, and only then after lengthy litigation, an individual would have to be very risk-loving to become an accident victim willingly. This seems very unlikely.

Notes

1. W. T. Harris, "A Public Choice Analysis of the Evolution of Tort Law: Liabilities, Lotteries, and Redistribution," *American Journal of Economics and Sociology* 51 (1992): 101–108.

2. Products liability is an important and growing area of tort law in the U.S. For example, in 1975 personal injury products liability cases accounted for about 2% of all federal civil cases, but by 1989, this figure had grown to nearly 6% (see W. K. Viscusi, *Reforming Products Liability* (Cambridge: Harvard UP, 1991), Table 2.2:18).

3. The argument will be limited to products liability law because this area is the focus of Harris's argument, and also because most other areas of tort law are governed by negligence. Two exceptions are workers' compensation and ultra-hazardous activities, which, like products liability, are governed by strict liability.

4. See W. Landes and R. Posner, *The Economic Structure of Tort Law* (Cambridge: Harvard UP, 1987), 287. Also, see A. M. Polinsky, and W. Rogerson, "Products Liability, Consumer Misperceptions, and Market Power," *Bell Journal of Economics* 14 (1983); and A. M. Spence, "Consumer Misperceptions, Product Failure, and Producer Liability," *Review of Economic Studies* 44 (1977).

5. See A. M. Polinsky, "Strict Liability vs. Negligence in a Market Setting," *American Economic Review,* 70 (1980); and S. Shavell, *Economic Analysis of Accident Law* (Cambridge: Harvard UP,

1987). Polinsky and Rogerson (1983) show how this conclusion is affected by market power on the part of producers. These analyses assume that all damages are borne privately, either by consumers or third parties (bystanders). However, there are potentially *public* costs as well, for example, when an accident causes a fire. Neither strict liability nor negligence will internalize these costs if only accident victims file lawsuits.

6. See S. Shavell, "Liability and the Incentive to Obtain Information About Risk," *Journal of Legal Studies,* 21 (1992).

7. In the U.S., most products liability cases are taken on a contingency basis by plaintiffs' lawyers. That is, the lawyer is paid only if the plaintiff recovers damages, either at trial or by settlement. The impact of contingent fees on the volume of litigation (and hence, on transaction costs) under both strict liability and negligence is examined in T. Miceli, and K. Segerson, "Contingent Fees for Lawyers: The Impact on Litigation and Accident Prevention," *Journal of Legal Studies* 20 (1991).

8. A waiver of liability is like a contractual internalization of product risk. In fact, during the nineteenth and early twentieth centuries, products liability was governed by contract law, which allowed accident victims to sue only those parties with whom they had a direct contractual relationship. This doctrine (referred to as "privity of contract") often barred consumer suits against manufacturers because a retailer or middleman was almost always present. Nevertheless, efficient internalization of risk was still possible through contractual means, except under the conditions noted in the text (*i.e.,* misperceptions and damages to bystanders).

9. See R. Epstein, *Modern Products Liability Law,* (Westport, CT: Quorum Books, 1980), for a comprehensive history of products liability law in the U.S.; and R. Cooter, and T. Ulen, *Law and Economics* (Glenview, IL: Scott-Foresman, 1988), 421–36, for a concise summary. A similar trend toward greater producer liability occurred in Great Britain and Germany during the twentieth century. See J. Finsinger, T. Hoehn, and A. Pototschnig, "The Enforcement of Product Liability Rules: A Two Country Analysis of Court Cases," *International Review of Law and Economics* 11 (1991) for a description of product liability law in these two countries. Although many factors have contributed to the development of product liability law, Landes and Posner (1987) argue that an important force promoting greater producer liability has been the increasing complexity of products during the twentieth century, which leads to high costs of information for consumers about product risk.

10. *Escola v. Coca-Cola Bottling Co.,* 24 Cal.2d 453, 150 P.2d 436 (1944).

11. See Viscusi, 1991.

Unintended Consequences

THE PRINCIPLE of unintended consequences notes the possibility and actuality of unanticipated, perhaps even, untoward, consequences from policies directed to other ends. An example that may be correct is the present threatened breakup of one of the world's luckiest and most blessed unions, that of Canada.

The family allowance system, now at least two generations old, kept children in school longer, particularly in Quebec, where their teachers could stress their real grievances and their imaginary or self-inflicted ones. This may help explain the present unfortunate constitutional situation.