

Economic Optimization of Tort Law

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I. Introduction

In this contribution the focus will be on the economic approach to tort law and hence the aims of tort law will be approached from the economic analysis of law. Obviously the introductory remarks provided to us by Koziol will also guide this economic approach, both as far as the structure of the contribution is concerned and regarding the questions to be addressed. The economic approach to tort law has already been applied in various projects executed for the European Group on Tort Law (EGTL). To a large extent we can hence base this contribution on the earlier work undertaken.¹ In this contribution we will obviously not repeat this earlier work but rather try to concentrate on the aims of tort law, trying to distinguish the legal approach to tort law, as it has so eloquently been explained in Koziol's introductory remarks, and the economic approach. As will immediately be made clear, the wording used in the economic approach to tort law at first blush seems rather different than the legal approach.

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As Koziol's introductory remarks make clear, in the legal approach compensation is strongly stressed as one of the and perhaps even the major aim of tort law; Koziol stresses in the introductory remarks at many places that deterrence should merely be considered as a secondary goal. There hence lays the main difference between the economic and the legal approach since for economists the main goal of tort law is

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¹ See, inter alia, *MG Faure*, *Strict Liability. Economic Analysis*, in: BA Koch/H Koziol (eds), *Unification of Tort Law: Strict Liability* (2002) 361 ff.

deterrence in order to provide incentives for prevention. Even stronger: compensation as such is in the economic approach not considered a goal of tort law, but merely a means, an instrument to force the potential injurer towards efficient prevention.

3 However, although the starting point and language of the legal and economic approach to tort law therefore strongly diverge, the question obviously arises whether that also means that those differences have real effect, eg when it comes to the question whether a particular tortfeasor should under specific circumstances be held liable for a specific damage caused to a victim or not. It may be the case that although the language and approach substantially differ, the effects (in terms of when a particular tortfeasor should be held to compensate) probably not. One of the goals of this contribution is therefore, on the one hand to focus on the differences in language and terminology, but on the other hand also to try to distinguish between form and contents, ie whether those differences are real when it comes down eg to the question whether an operator of a nuclear facility should be bound to a strict liability rule or rather to a fault regime.

4 The title of this contribution refers to ‘economic optimization’. That obviously raises the question of what is meant with such an ‘optimization’. As will be explained below, from an economic perspective the goal of tort law, sometimes more broadly referred to as accident law,² is not to provide compensation to victims, and not even to prevent all accidents at all costs. Optimization refers to the fact that preventing accidents is also a costly activity. Hence the goal of tort law should be to prevent those accidents that are worth being prevented on economic grounds, ie where the marginal costs of prevention are lower than the marginal benefits in reduction of the accident risk. The economic approach therefore sees tort law as an instrument to provide incentives to parties in the accident setting (both injurers and victims) to take ‘optimal’ preventive measures, not to avoid all accidents at any cost. The simple reason is that if the marginal prevention costs were higher than the marginal benefits in accident reduction, social welfare would be decreased.

2 The term accident law is based on the seminal book of *S Shavell*, *Economic Analysis of Accident Law* (1987) and encompasses not only tort law, but also other instruments aiming at prevention of accidents (like regulation) as well as other instruments aiming at compensation (such as insurance).

This contribution will address the aims of tort law from an economic perspective, but also address a few specific issues and cases that have been identified in Koziol's introductory remarks. A brief discussion of specific cases also has the advantage that it may allow a more careful analysis of whether the economic and legal approaches merely differ in wording or whether there truly are substantive differences.

The remainder of this contribution is set up as follows: first, the economic goals of tort law will be outlined on the basis of the relevant literature (II); this will be followed by a critique of the deterrence perspective (III). However, notwithstanding the critique of the deterrence perspective that can be raised, equally strong (and from an economic perspective probably stronger) criticism of the compensation perspective can also be raised (IV). Section V will discuss the dichotomy between strict liability and negligence, showing that, under the traditional fault rule, no compensation to victims will be provided, although optimal deterrence can be achieved. Section VI will address non-pecuniary losses, more particularly from the perspective of whether non-pecuniary losses should serve the goal of deterrence or compensation. Section VII discusses punitive damages and section VIII concludes.

II. Economic Goals of Tort Law: A Formal Approach

A. Reducing the costs of accidents: Calabresi

In his ground-breaking book, the *Costs of Accidents*, Calabresi clearly opts for a normative approach to the accident problem: first, the approach must be just or fair; second, it must reduce the costs of accidents.³ This second goal stresses the preventive function of liability rules and is formulated as the reduction of accident costs in order to increase social welfare.

Calabresi divided the costs of accidents into three categories: primary, secondary and tertiary costs. The primary cost reduction relates to the number and severity of accidents. The secondary cost reduction

3 *G Calabresi, The Costs of Accidents. A Legal and Economic Analysis* (1970) 24.

concentrates on reducing the societal costs resulting from accidents.⁴ The third sub-goal of accident cost reduction is the reduction of the costs of administering our treatment of accidents.⁵ The aim of these tertiary costs is thus to reduce the costs of achieving primary and secondary cost reduction. In order for liability law to be efficient, total accidents costs (primary, secondary and tertiary) should be minimized.

9 Calabresi indicates that the primary cost reduction can be reached through either general deterrence or specific deterrence. Within a general deterrence approach, the government can rely on the market to deter potential wrongdoers. When an enterprise (as a result of enterprise liability) is held to compensate the costs its activity causes, dangerous activities will become more expensive and the enterprise will, as a result of market forces, have an incentive to increase safety.

10 General deterrence in this perspective can therefore reduce primary accident costs in two ways: when an individual has to pay the full price (including the accident costs) in case a dangerous activity is performed, this will lead to a behavioural change whereby a safer activity is chosen. The second and perhaps more important way general deterrence reduces accident costs is that it encourages us to make activities safer.⁶ Calabresi notices that this of course assumes that the person who is creating the risk also has information on costs and benefits of preventive measures. General deterrence, so Calabresi argues, thus creates a market for developing cost saving substitutes and thus leads to a minimization of accident costs thanks to market forces.⁷

11 In addition to general deterrence, Calabresi argues that primary accident costs can also be reduced through specific deterrence. At its extreme specific deterrence suggests that all decisions as to accident costs should be made collectively, through a political process. In this case, it is society that collectively decides how much of each activity should be allowed and the way in which it should be performed.⁸ Calabresi advances many arguments why in some cases specific deterrence may be preferred to general deterrence. One argument can be that individuals do not know what is best for them; another that accidents may

4 This can to some extent be equalized to the compensation of victims although Calabresi rightly mentions that this is somewhat misleading – *Calabresi* (fn 3) 27.

5 *Calabresi* (fn 3) 28.

6 *Calabresi* (fn 3) 73.

7 *Calabresi* (fn 3) 74f.

8 *Calabresi* (fn 3) 95.

involve non-monetisable costs or that moral judgements are involved. Moreover, general deterrence (through the market) cannot effectively reach some categories of activities. For all of these reasons because of the limits of the market mechanism (through general deterrence) specific deterrence may intervene with prohibitions and restrictions, limitations on specific activities and penalties in the case of non-compliance.⁹

Calabresi indicates that, from the general deterrence point of view, the question arises which part of accident costs have to be allocated to an activity that caused the harm; from a specific deterrence approach, the question arises which regulation is indicated to deter a specific dangerous activity. In practice, however, there is some mixture between specific deterrence and a market control of accidents (through general deterrence).¹⁰

The crucial question of how accident costs have finally to be allocated is analysed on the basis of the concept of the 'cheapest cost avoider'. Within the market mechanism (general deterrence) an initial 'rough guess' has to be made eg ruling out as potential loss bearers those activities that could reduce the costs being allocated only at what would obviously be too great an expense.¹¹ Next, the second guideline is to seek the maximum degree of internalization of costs, for example due to insufficient sub categorization, due to transfer or due to inadequate knowledge. This means that in general Calabresi holds that an externalization of costs from pedestrians or drivers to taxpayers in general should be avoided unless this allocation of costs can take place at relatively lower administrative costs.¹²

A few further guidelines are provided by Calabresi in the search for the 'cheapest cost avoider'. One guideline is obviously that if finding (or allocating cost to) the cheapest cost avoider is more expensive (in administrative costs), the cost saving achieved by the seemingly better allocation may not be worth the administrative costs borne to find it since total costs have to be minimized.¹³ Finally, costs should also be allocated in such a way that the likelihood of errors in allocation will

9 *Calabresi* (fn 3) 95 ff.

10 *Calabresi* (fn 3) 113.

11 *Calabresi* (fn 3) 140.

12 *Calabresi* (fn 3) 144 ff.

13 *Calabresi* (fn 3) 143 f.

be corrected in the market. This criterion assumes that, despite transaction costs, a tendency exists for the market to find the cheapest cost avoider and influence him by bribes. If there is hence uncertainty of who is the cheapest cost avoider, accident costs should be charged to the person who can enter into transactions more cheaply, by Calabresi referred to as ‘the best briber’.¹⁴

15 Calabresi indicates moreover that the market mechanism under general deterrence has the advantage that the decision can be made empirically by trial and error. The individuals who make the determination most accurately will benefit most in the market. The great advantage of the general deterrence of the market is, in the words of Calabresi, that it is a very effective trial and error device.¹⁵ Here Calabresi indicates a substantial disadvantage of specific deterrence under the collective decision-making process. Trial and error is not possible in the same way as the market can do so under general deterrence and moreover, errors in the case of specific deterrence (for example in making wrong sub categories) can result in a remaining wrong allocation which cannot be corrected through the market. Once a wrong decision has been made under specific deterrence (regulation), a new decision will be possible to correct the earlier one.¹⁶

16 A great deal of the *Costs of Accidents* is thus devoted to the optimal way in which, using the notion of the cheapest cost avoider, society can (either through general or specific deterrence) minimize the total sum of accident costs.

17 Quite essential, also from the perspective of the economic ‘optimization’ of tort law, is that Calabresi also makes clear that prevention is costly and that therefore the goal of tort law cannot be to prevent all accidents at all costs. In the words of Calabresi: ‘Our society is not committed to preserving life at any cost’.¹⁷ Calabresi hence applied the basic economic insight that ‘we use relatively safe equipment rather than the safest imaginable because – and it is not a bad reason – the safest costs too much’.¹⁸

14 Calabresi (fn 3) 150 ff.

15 Calabresi (fn 3) 186 ff.

16 Calabresi (fn 3) 181 ff.

17 Calabresi (fn 3) 17.

18 Calabresi (fn 3) 18.

B. Prevention through deterrence

At around the same period in which the seminal publications from Calabresi were written a different type of scholarship emerged, addressing the goals of tort law from a more formal economic perspective.

From an economic perspective a liability system has an important social function in remedying market failures.¹⁹ When economic actors lack information on how their activities impact other parties, whether positively or negatively, those impacts to third parties are called ‘externalities’;²⁰ they are external in the sense that pricing data is not transferred between the parties and thus the pricing data is external from the decision-making process of the first actor.²¹ Thus, liability rules can play an important role in curing market failures caused by externalities.²²

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- 19 For a general survey of the economic analysis of environmental liability and the role of tort law in that respect, see *L Bergkamp*, Liability and Environment. Private and Public Law Aspects of Civil Liability for Environmental Harm in an International Context (2001) 67 ff; *K De Smedt*, Environmental Liability in a Federal System. A Law and Economics Analysis (2007) 28 ff and *M Wilde*, Civil Liability for Environmental Damage. A Comparative Analysis of Law and Policy in Europe and the US (2nd edn 2013) 138 ff.
- 20 Pigou is the economist most commonly given credit for popularizing the concept of externalities. He advocated that adverse externalities could be offset by imposing a tax on the actor creating the externality and thus forcing that actor to include, or internalize, those costs otherwise imposed on third parties. See *AC Pigou*, *The Economics of Welfare* (1924).
- 21 See *idem*. For an applied discussion on optimal enforcement policies to address existing externalities, see *R Van den Bergh/LT Visscher*, Optimal Enforcement of Safety Law, in: *RV De Mulder* (ed), *Mitigating Risk in the Context of Safety and Security. How Relevant Is a Rational Approach?* (2008) 29.
- 22 As will be argued below there are obviously many other instruments that could cure externalities, other than liability rules. One of them is *ex ante* regulation by government, which will be discussed below in no 50 ff; yet other solutions to cure externalities are market-based instruments, such as emission trading which has become popular as an instrument to mitigate climate change. See *MG Faure*, Effectiveness of Environmental Law: What Does the Evidence Tell us? (2012) 36 (2) *William & Mary Environmental Law and Policy Review* 293 ff, on the different instruments to remedy environmental pollution as well as on their optimal combination. In a related area, that of nuclear liability, international conventions provide low limits, so-called ‘liability caps’, on the liability of the nuclear operator. It has been held that those limits on liability constitute a subsidy that leads to an insufficient internalization of the externality caused by the nuclear risk. For estimates of those subsidies, see inter alia *JA Dubin/GS Rothwell*, Subsidy to Nuclear Power through Price-Anderson Liability Limit (1990) 8 (3) *Contemporary Economic Policy* (CEP) 73 ff; *MG Faure/K Fiore*, An Economic Analysis of the Nuclear Liability Subsidy (2009) 26 (2) *Pace Environmental Law Review* (PELR) 419 ff; and