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Efficient incentives from obligation law and the compensation principle

Urs Schweizer*

University of Bonn, Germany

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ABSTRACT

The compensation principle provides an analytical link between the requirement to compensate for deviations from legal or contractual obligations and the economic desideratum of rules providing efficient incentives. Quantifying damages suitably in line with the difference hypothesis, even relative to an inefficient obligation profile, would ensure the compensating goal being achieved as required for the compensation principle. The paper applies this insight to various settings from tort and contract law, leading to new results but also to a unifying perspective on findings from the existing literature.

1. Introduction

Legal rules are called efficient if they generate incentives for strategically acting parties to take decisions leading to a welfare maximizing outcome.

Obligation law provides general rules for contractual and tort relationships. If a debtor deviates from a (contractual or legal) obligation, the law offers remedies to creditors who suffer from harm caused by the debtor's deviation. These remedies aim at compensating creditors.

The compensation principle, finally, refers to an analytical link between the legal requirement of compensation and the economic concept of efficient rules. If each party is compensated for unilateral deviations from an efficient reference profile by the other party then all Nash equilibria of the underlying game are efficient and payoff equivalent. In fact, a party's payoff cannot exceed total welfare minus the other party's payoff. Therefore, if the first party unilaterally deviates from the efficient reference profile, welfare is lower but the second party's payoff is not and, hence, the first party would be worse off under such a deviation. Since unilateral deviations lower payoffs, the efficient reference profile must be a Nash equilibrium indeed.

The compensation goal is, in particular, achieved if creditors are awarded damages in line with a suitable version of the difference hypothesis. In Germany, this hypothesis is attributed to Friedrich Mommsen, a legal scholar from the nineteenth century. Accordingly, damages should account for that part of the harm that was caused by the deviation from the obligation and should be calculated as the difference of the hypothetical (hence counterfactual) value of the creditor's assets if the debtor had met her obligation and their actual value, given that actually she has not.

While Mommsen has published his work in 1855 long before obligation law was codified in Germany, textbooks till today refer to it. Legal practice, however, tends to interpret the difference hypothesis far too narrowly and to disregard it, in particular, in cases of uncertain causation.

* Correspondence to: Department of Economics, University of Bonn, Kaiserstr. 1, 53113 Bonn, Germany.
E-mail address: schweizer@uni-bonn.de

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In common law countries, damages in line with the difference hypothesis would just be called expectation damages, without giving credit to any legal scholar and without referring to a difference hypothesis explicitly. In any case, keep in mind that expectation damages (i.e. damages in line with the difference hypothesis) are quantified relative to the parties' obligations, be they of contractual or legal origin.

Traditional economic analysis of tort law has shown that, except for strict liability, most damages rules including the negligence rule with and without a defense of contributory negligence as well as other related schemes provide efficient incentives for all parties. The economic analysis of contract law, in contrast, has uncovered inefficiencies in the form of overreliance by the creditor. At first glance, such a discrepancy in terms of efficiency seems puzzling, in particular under the legal regime of an obligation law that governs contractual and tort relationships by common principles.

The puzzle is easily resolved. While, in tort cases, courts are expected to specify obligations at their efficient level, parties to a contract define obligations themselves. To economize on transaction costs, they may deliberately abstain from taking all conceivable contingencies into account. The literature, in fact, has mainly focused on completely non-contingent obligations which parties stipulate even in the presence of uncertainty. For an early contribution of this type, the reader is referred to Shavell (1980). Parties rather rely on remedies for breach of duties as offered by contract law whenever corresponding contingencies arise. Such non-contingent contracts define obligations that may fail to be efficient (for some contingencies at least) and are regularly claimed to generate excessive incentives for reliance investments under expectation damages.

The present paper, in contrast, takes a broader look at the difference hypothesis and propagates it even in cases of uncertain causation. To begin with, a purely mechanical exercise uncovers the conditions, which damages relative to a one-sided inefficient obligation profile must fulfill, such that parties are still compensated for unilateral deviations from an efficient reference profile. As then follows from the compensation principle, damages fulfilling these conditions will still generate efficient incentives for both parties. This version of the compensation principle will be referred to as difference principle and damages are called in line with the difference hypothesis if they meet the conditions of this difference principle.

As it turns out, if the party facing the inefficient obligation breaches efficiently and if this breach benefits a second party then this second party must return her enrichment in order to generate incentives for efficient breach by the first party. Moreover, if the second party that is facing an efficient obligation deviates, then the first party is entitled to expectation damages based though on the efficient obligation and not the action actually chosen by the second party. Such damages, implicitly referring to a reasonable person standard, effectively put a cap on damages claims which may legally be justified on grounds of contributory negligence. In any case, such damages will generate first-best incentives even if they are specified relative to a one-sided inefficient obligation profile. This, in a nutshell, is the message behind the difference principle.

As an important application, the proposed damages regime will be spelled out for a hold-up situation involving non-contingent contracts and investments of selfish, cooperative or even hybrid nature. To implement the proposed damages regime, courts must be able to detect deviations of relationship-specific investments from their efficient level. In the traditional hold-up literature, investments are usually assumed to be hidden actions and, from that perspective, the present paper does not solve the hold-up problem.

In fact, the informational setting examined by the present paper would allow for many other efficient mechanisms. Yet, the additional merit of the proposed scheme stems from being exclusively based on the logic behind expectation damages (or the difference hypothesis), in principle, a widely accepted legal concept.

Goeller and Hewer (2014) have examined compensation rules for takings that provide two-sided efficient incentives for purely selfish investments. Their main result can easily be reframed as a special case of the difference principle as propagated by the present paper. The same holds true for Schweizer (2006), who has proposed a bilateral damages regime leading to an efficient outcome in a setting of cooperative investments.

The present paper generalizes these earlier findings, allowing for investments of any type. Moreover, while these earlier contributions have assumed courts to know counterfactuals, the present paper adds a damages regime in line with the difference hypothesis which courts could implement even if counterfactuals remain unknown to them.

The difference principle as proposed by the present paper refers to strategic interaction among parties expressed in normal form even if sequential choice is at stake. As a consequence, the efficient reference profile will form a Nash equilibrium of the underlying normal form game but may fail to be subgame perfect in the extensive form. The subgame perfect equilibrium outcome must be first-best nonetheless. In fact, subgame perfect equilibria are always Nash equilibria of the corresponding normal form game. Since Nash equilibria of this game are payoff equivalent, as follows from the compensation principle, the subgame perfect equilibrium has to be first-best as well.

Off the equilibrium path, even the subgame perfect continuation may fail to be ex post efficient, which paves the way for voluntary renegotiations. Yet, as both parties must agree, renegotiations will reinforce the compensation goal being achieved. It then follows from the compensation principle that not even (anticipated) renegotiations off the equilibrium would distort investment incentives.

Many economic studies of tort law have dealt with unidirectional externalities in the sense that the injurer's payoff function (before damages) does not depend on the victim's contributory precaution investments. In such a setting, if the victim moves second, then damages in line with the difference hypothesis prove flexible enough to generate efficient incentives also off the equilibrium path. Based on the work of Rea (1987), Grady (1988) and Kornhauser and Revesz (1991), the textbook by Miceli (2008) nicely summarizes earlier findings on liability under sequential moves. Most of the rules he examines, however, fail to generate efficient incentives off the equilibrium path with the exception of marginal cost liability as pioneered by Wittman (1981). In spite of their nice properties, however, (as Miceli argues) courts do not seem to follow marginal cost liability in practice.

The justification proposed by the present paper, in contrast, rests on damages in line with the difference hypothesis. As this concept is of legal origin, the proposed damages regime may be of practical relevance nonetheless.

On top of truly new results, the paper also takes a fresh look at well-known findings from the existing literature on the efficiency of a whole variety of damages regimes for the setting of the accident model. As all these regimes satisfy the requirements of the compensation principle, a single proof turns out sufficient to establish all such efficiency results at once. As a fringe benefit of the approach, much weaker assumptions are needed compared with the earlier literature, which predominantly has relied on calculus combined with concavity assumptions.

For sake of completeness, let me also mention Schweizer (2005) on the economic analysis of obligation law. While, in that paper, I had focused on the mathematical saddle point property, the present paper takes a more legal perspective by referring to the compensation goal and the difference hypothesis instead.