

Klick  
Law and Economics of the Firm  
Final Exam  
Summer 2020

You have 24 hours to complete this exam, but the latest you may turn it in is 11:59 pm on June 16, 2019. You may use your casebook, notes, and commercial outlines in the completion of this exam, but you may not confer with anyone else about it during the exam period (i.e. June 12 at 9:00 am through 11:59 pm on June 16). Each question (1 and 2) is equally weighted subject to your choice in question 3. Good luck.

1. To reduce the incidence of police officer wrongdoing, some economists have suggested that individuals who are unjustifiably (i.e., some standard tort defenses would be allowed such as self-defense, though, perhaps, assumption of risk might be disallowed as a defense) harmed should be able to bring lawsuits where any money damages (compensatory, non-economic, and/or punitive) would be paid out of collective police pension funds, and pension amounts paid to all existing and future beneficiaries would be lowered accordingly (i.e., general municipal budgets would not make up any pension benefit shortfalls caused by liability awards). Evaluate the incentive and efficiency effects, pro and con, of this proposal and offer any details that could be added or modified to improve those incentive and efficiency effects.

**The kernel of this idea can be found in the Becker/Stigler article where we rely on an implicit bonding mechanism. In their model, for jobs where monitoring is hard but where it is important to ensure honest performance, we pay a sub-market wage during the period of work with the promise of a large pension at the end as long as the worker has not been caught engaging in wrongful behavior on the job. In practice for police, however, it sometimes appears as though the mechanism falls short because detection of wrongful behavior is low or because various actors in the system are reluctant to enforce the penalty of revoking the pension. If the probability of detection is low and/or the probability of enforcing the penalty is low, the Becker/Stigler approach is unlikely to incentivize police officers effectively.**

**The proposed modification has the potential to remedy these problems. In terms of increasing the probability of detection, expanding the incentive for victims to sue will increase scrutiny of police wrong-doing, presumably leading to a higher likelihood of detection of that wrong-doing. Further, by making all members of the police force implicitly responsible (through lower expected pension payments), the proposal may induce more self-policing within the force. If there are early indications that a particular officer is high risk, police supervisors may be less likely to retain the officer or put him/her in situations where the officer can generate liability. Fellow officers may also be more willing to "snitch" on bad behavior at early stages so as to have problematic officers removed before they generate liability.**

**Enforcement of the penalty (i.e., loss of job and pension bond) is often inhibited by union protections. Unions will often fight against applying the penalty when an officer is found to have acted wrongly. Under the current system, there is little cost to the union of protecting a bad apple and arguably a benefit as members will value this protection. Under the proposal, however, expected pension benefits for the average police officer will be higher if bad apples**

are culled from the force. That is, weeding out high liability risk officers would be compatible with the union's incentives under the proposed system.

While the collective nature of the punishments under the proposal are attractive for the foregoing reasons, collective incentives are somewhat blunted as opposed to individualized incentives (e.g., have the officer individually satisfy the tort judgment). This downside, however, is largely theoretical. First, there are many impediments to securing a verdict against an officer. For example, qualified immunity protects officers from facing liability in many instances of wrong-doing (note: nothing in the proposal does anything to "fix" this issue, so if qualified immunity would also make it difficult to secure a judgment satisfied from the pension funds, the proposal might be impotent as well). Further, even when a judgment is secured, the officer is generally indemnified either by an insurer or by municipal funds. Thus, it is not clear that individual liability does much to incentivize officers currently. For these reasons, perhaps not much is lost by moving in the collective direction, and the collective self-policing benefits are clear gains. It is also possible that the municipal satisfaction of judgments (either directly, or indirectly through higher insurance premiums) creates perverse incentives (e.g., judges or juries worried about effects on municipal finances from awarding damages; prosecutors worried that convictions will increase the likelihood of a tort judgment, etc) which might be avoided if tort judgments are satisfied through the pension fund.

More worrisome downsides might include the need to pay officers more in total (or the reduction in the quality of individuals willing to be police officers) and a potential reduction in effort expended by officers on the job. Regarding the effects on pay, the proposed system clearly generates lower expected wages (since pension payments will be reduced at least to some extent) and it also generates risk and uncertainty with respect to the realized value of pension payments. Individuals will not bear this risk and uncertainty for free, therefore they will demand some combination of higher wages and increased pension contributions. If pay and/or pension amounts are not increased, the individuals with better outside options (which may be the individuals with superior skills and attributes) will not seek to be police officers.

As for on-the-job performance, if expending more effort (responding to calls more quickly, being more proactive in discovering crime, etc) increases the likelihood of an incident that could give rise to a tort suit, a rational strategy would be to not expend effort (e.g., spend more time sleeping in your car or taking longer coffee breaks). To some extent, this incentive already exists, but the proposal would likely intensify it. Perhaps one could try to build in other incentives (carrots might include more performance-based promotions and salary increases; sticks might include allowing tort suits for police non-response), but such incentives are difficult to operationalize (how does one judge good performance of a police officer? Measurement problems abound – many critics point to an emphasis on arrest and crime statistics as generating problems where cops focus on easy arrests that do little to make society safer as well as massaging crime statistics to make things appear better than they are).

2. U.S. antitrust law is governed by the so-called consumer welfare standard (i.e., potentially anti-competitive mergers or practices are supposed to be judged on whether they reduce the welfare of consumers). In many settings, empirical evaluation of whether something is likely to harm consumer welfare focuses on price effects. For example, the evidence presented by

experts in the Staples/Office Depot merger challenge examined whether office superstore competition, independently of competition from other sellers of office consumables, significantly affected prices charged by Staples and Office Depot. What are the limitations of this focus on price as a metric of consumer welfare? Describe any other practical/feasible ways courts could examine consumer welfare, noting their pros and cons relative to the price metric.

**Price is only one element of consumer welfare. Presumably, consumers also get value out of quality (e.g., craftsmanship, durability), customer service (e.g., delivery speed, ease of buying), legal rights associated with the product (e.g., warranties, liability assignments), variety/customizability (e.g., model availability, options), associated products and services, etc. A singular focus on price in antitrust would ignore these other dimensions.**

**While it is conceptually possible to think of metrics for these other dimensions of consumer welfare (e.g., how long does the product last, are the contract terms more “pro-consumer”, are there more options available, etc), because we view welfare subjectively, there is no way to *a priori* assume how much these elements affect consumer welfare or how consumers are willing to make trade offs among them. A higher-price, higher-quality alternative may be preferred for some products (but not others) for some consumers (but not others). Likewise, in some instances, more “consumer-friendly” contract terms, for example, may actually make consumers worse off (e.g., if these terms come with a higher price but the consumer doesn’t value the terms very highly).**

**Arguably, changes in quantity may be a useful proxy for changes in consumer welfare if we are committed to subjective values and we want to account for these other non-price elements of welfare. A merger that leads to high prices, without any contemporaneous improvements along these other dimensions, will lead consumers to buy less of the product (all other things equal), leaving them worse off. However, if the merger leads to higher prices but also better quality that more than compensates consumers for the higher price (valued by the consumers subjectively), they will buy more of the product (again, all other things equal). As compared to trying to directly measure these other elements, quantity does not require external judgments about what is good or bad, nor does it require strong assumptions about how people generally trade off across these other dimensions.**

**Another approach would be to look to market reactions of merger proposals or challenges to firm behaviors. While it is true that anti-competitive mergers, practices, etc and pro-competitive ones will both tend to increase the share price of the firm of interest, pro-competitive and anti-competitive outcomes have very different predictions for competing firms. If, for example, a merger is seen to be anti-competitive, the merging firms will raise prices which will allow competing firms to also raise prices. However, if the merger is seen to be pro-competitive, the merging firms can lower prices due to achieved efficiencies, while the competing firms will be pushed to lower prices even without having achieved any additional efficiencies (and therefore their stock price will decline). This approach, while it has the benefit of aggregating diffuse judgments and information, does assume that the market “gets it right” which may not be accurate.**

3. Please choose one question (1 or 2) to count double or indicate you want each question to count equally. If you do not make your choice clear, I will choose the least advantageous option for you (i.e., double count the question on which you did worse).