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Buyer and Seller Beware!

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What system of product liability suits the market process best? What system educates the consumer best about the essence of the market economy? Since in a paper as brief as this one, no comprehensive discussion of product liability and the liability systems effecting it can be given, I will concentrate on the Austrian perspective. Subjectivism and entrepreneurship are emphasized. Contrary to most modern AustriansCwho do prefer a system of strict liabilityCI find the answer in the old system of buyer and seller beware.

Product liability, part of tort law, deals with harms arising from commercial products. It is mostly about physical injuries to the consumer's life and property, caused by defective or unreasonably dangerous products. For the neoclassical, the development seemed to be driven by a cost-benefit calculus based on standard criteria of efficiency. Mainstream law and economics in its positive dimension supposes that the liability system itself and every change in it are efficient. In its normative dimension it addresses the issue of how legal rules might be formulated to maximize the value of production. The judge, using one of the most famous formulas in the economic analysis of law, the so-called Hand Formula after Judge Learned Hand (cp. Cooter and Ulen, 1988, pp. 360-362), balances expected accident costs against the costs of making the product safer. A defendant is guilty of negligence if P times L is greater than B. Where P is the probability, a loss will occur, L is the value associated with the loss, and B the cost associated with preventing it.

What was the development in liability the neoclassicals can explain? Richard Epstein in his 1980 book on product liability law distinguishes three stages. From roughly 1850 till the end of the First World War the burden was upon the consumer. He had to ferret out and correct all manners of product weaknesses and deficiencies. Otherwise, there was the fear of grave administrative complications. The courts threatened to be overwhelmed by the sheer task of going through a full post-accident inquest. This had to be done in an ever-growing number of cases examing how all the parties performed. There also was the fear of adverse social consequences: the economic ruin of the producer. Till the end of the 60s, the burden of loss was evenly distributed between producer and consumer. There was a balance between the dual constraints of substantive justice and administrative need. A negligence rule imposed an obligation to satisfy a legal standard of care, usually defined as a reasonable level of care. Today the producer bears the burden. The philosophical premises underlying the notion of liability have changed fundamentally. Administrative necessities and contractual models for setting liability are now not given much weight. Liability is a matter of public law models of regulation, such as risk spreading (producers act as insurers by spreading the cost of the accident across consumers through higher product prices) or deep pockets. In this third stage strict liability dominates. It makes the injurer bear the cost, regardless of the extent of his precautions. No legal standard of precaution is relevant to the assignments of costs. Notice that, to the neoclassical, the strict liability rule is the cost-benefit rule.

What most modern Austrians say

Austrians claim—among all other schools of economic thought—to have most consistently adhered to the postulate of

economic realism (Caplan, 1999). What then of the real consumer who acts in a world of genuine surprise. Austrians also are said to prefer a system of strict liability (Christainsen, 1990; Cordato, 1992; Rizzo, 1985; Rothbard, 1982). Why? Austrians prefer abstract rules: stable rules the government cannot change at will. Rules enhance the chances of an order in which individuals pursue and attain their goals. A[I]n order to pursue goals and make plans it is necessary to have a system of property rights that is clearly defined and that each individual can count on into his foreseeable future. Any involuntary alteration of a given property rights structure will necessarily interfere [...]@ (Cordato, 1980, p. 402). Property rights are the spheres of freedom of action by each individual. Two axioms are basic to the system of property rights. One, every man is a self-owner. He has the absolute jurisdiction over his own body (the axiom of self-ownership). And two, each person justly owns whatever previously unowned resources he appropriates or Amixes@ his labor with (the axiom of Ahomesteading@) (Rothbard, 1982, pp. 60-61). For an Austrian, liability is Aanalyzed in terms of institutional efficiencyCthe certainty and stability that these rules impart to the social framework@ (Rizzo, 1980, p. 291). Strict liability fits in naturally. Costs and benefits do not have to be balanced. Negligence, however, always needs a balancing of interests. We need a particular hierarchy of means and ends. For the Austrians, tort is based on ethics not economics (Rothbard, 1979, p. 95). He who causes harm should compensate the victim.

To sum up, Austrians reject dynamic change in the law on the basis of economic efficiency; they prefer a static, stable system. Appropriate rules of the game, however, are necessary. As Hayek said: ACompetition is a procedure of discovery [...]. To operate beneficially, competition requires that those involved observe rules@

(1988, p. 19). Competition is not unconditional, but is conditional subject to certain constraints. So the question becomes how competition and entrepreneurship can be conditioned in their working properties by alternative rules for product liability. Is strict liability the only Austrian approach possible? I want to highlight the Austrian elements of subjectivism and entrepreneurship and see where they take us.

Subjectivism

For liability to be Austrian, first, it should be able to cope with subjectivism. This cannot be ignored. Although some believe that it is impossible to incorporate it in a system of liability. Subjectivism should lead to a system in which all compensation is astronomically high. Why not punish someone who makes a scratch on my car with capital punishment (De Geest, 1994, p. 496, cp. p. 491)? But what is the alternative? For the Austrian, notions of objective specificity and precision widely used in the natural sciences have no place into a science of human action. Facts deployed in social science are merely opinions: they never exist as a consistent and coherent body. Austrians adhere to Hayek who said Ait is probably no exaggeration to say that every important advance in economic theory during the last hundred years was a further step in the consistent application of subjectivism@ (1952, p. 31). For the subjectivist, a price (money) does not measure value. In the act of exchange, we can only compare one thing with another thing. Value is an internal, subjective state that is immeasurable and not amenable to comparison. In other words, value cannot be compared among persons and money cannot be used for such comparisons (Mises, 1953, p. 38).

Human action is based on individual purposes; gains and losses are personal, noncomparable, and non-additive. Cost comparisons

done by an outside observer are impossible. How can this element be incorporated into a system of liability? Fortunately, A[j]ust as most intentional assaults involve assailants and victims who already know each other well, most unintended injuries occur in the context of commercial acquaintance [...]@ (Huber, 1988, p. 5). Most accidents are part of the realm of human cooperation, and not of an unchosen relationship and collision. In other words, most accidents are part of consent (private choice) not of coercion (public choice). If this is the case (the case of the innocent bystander comes below), what comes to the fore as the element to focus on is the implicit or explicit contract made. It Aallows us to weight the risks and benefits of our actions in the objective coolness of the beforehand rather in the emotional heat of the aftermath@ (Huber, 1988, p. 226). The best protection against accidents are not measures taken after an accident happens but Ain the freedom to make considered, binding choices beforehand@ (Huber, 1988, p. l8). Private choice and individual consentCboth deliberately madeCare what it is all about. We make a distinction between harmful acts and tortuous ones. What makes the difference is consent, or lack of it. Not all harmful acts are torts. No harm is done to one who is willing. A person who comes willingly to a risky situation assumes the risk of his activities and cannot blame someone else later for the accident. Parties allocate risks and responsibilities in any way they choose. First party insurance, specified compensation, and assumption of risk prevail over liability-driven compensation.

However, are not transaction costs too high to make contracts? First, transaction costs are costs like any other. We live in a world of costs. Everybody wants them lower; just as every consumer wants prices to be as low as possible. Second, of course people cannot contract with every firm individually. Firms will compete in offering

different packages of liability. As standard contracts are developed, transaction costs go down. Third, it is surely not possible to find a measure of efficiencyCas the neoclassicals are inclined to doCfrom a world without transaction costs. What judges are asked to do is to allocate when transaction costs are prohibitively high. But that is the same as the solution to use hypothetical markets in the so-called calculation debate (O'Driscoll, 1980, p. 356). Indeed, it is the old problem again: ACan we do without the market?@ Austrians emphasize the division of knowledge and its growth. Freedom of contract is necessary, not because it produces perfect efficiency, but because it produces more efficient outcomes than judicial intervention does. The system encourages the full use of human knowledge. This brings us to our second Austrian tenet.

Entrepreneurship

Austrianism implies entrepreneurship. It is naturally stimulated. If contract is the norm, people suffer or enjoy the consequences of their decisions. One is alert; entrepreneurship is encouraged. New things can be discovered; we can be genuinely surprised. Strict liability implies coercion and less choice. What is needed is not less but more choice (Huber, 1988, p. 224). A system of tort says no. The only freedom left is not to discover, not to innovate. Contract gives the individual the freedom to make his own private choices. It stands against the judge's public choice under a system of strict liability.

People have the freedom to take or limit liability through *ex ante* agreements. They have the opportunity through voluntary exchanges (the contracting process) to use their property rights. Circumstances change and people are different. That is why an exchange, if voluntary, always benefits the exchanging parties. Strict liability in modern product law, however, negates any attempt to limit liability

through agreements. A[...T]he concept is associated with the nearly complete abandonment of contract and the idea that the plaintiff should never bear the costs of his or her actions@ (Cordato, 1992, p. 101). The world, however, is one of error and risk: genuine surprise. How can a contract with its implied distribution of liability be just if it is based on the erroneous valuation of one or both of the partners? The market process is all about the correction of error. Entrepreneurship depends on error, of which we are never fully aware. The question is, AIs the errorCyes or noCinduced by one party, either positively or tacitly, on the basis of which consent is fraudulently obtained@ (cp. Kirzner, 1979, p. 217). Genuine error, however, is completely different. Genuine error and its counterpart, genuine surprise, are unexpected. Such a possibility is never imagined. The correction of these errors should be seen as a gain; as something that was not there beforeCfor better or worse. The possibility of genuine error is the spark that switches on entrepreneurial alertness. For both consumer and producer it is the core of the market process (Kirzner, 1989, p. 107). Also, why not bring liability back to the law of contractsCback, so to speak, to Epstein's stage one?

Caveat emptor

The rule that has prevailed since times immemorial, or at least since the fifteenth and sixteenth centuries (Huber, 1988, p. 22), is *caveat emptor*. ALet the buyer beware!@ But since the seller was bound by the terms of the deal too, the rule would more correctly have read *caveat emptor et vendor*. The whole idea of contract law of making buyer *and* seller keep to their agreements and promises is rooted in a notion of consumer protection.

We have an innate sympathy, however, against the notion of *caveat emptor*. Indeed Adam Smith spoke of sympathy as one of the

driving forces of the market. The invisible hand produces order. It manifests itself in two ways: first, in our sympathy for our fellow man and, second, in competition among producers and consumers. Both forces control our self-interest. And indeed, the most powerful agent in the change in tort law, from *caveat emptor* to the notion that the buyer should never bear the costs of his action, has been sympathy (Huber, 1988, p. 190). AWho can fail to be angered by the devastating injury to a young child, or by the maiming of a woman in the prime of her life, or by the slow suffocation of a retired factory worker? Every accident was recharacterized as an assault, the victim then being invited to make a bid for our sympathy in court@ (Huber, 1988, p. 191).

Contract law, however, seems to be returning to the dark days of the Middle Ages; back in time to when capitalism started. Perhaps sympathy was too expensive in the old days, but today society can afford to help its fellow men. Contract law places a heavy burden on the weak, ordinary consumer: the hapless victim of an accident. Who is he? Everyone. People are ignorant of most dangers and no experts on product liability. It cannot be only the dullards who need protection. For Athen the question becomes: how can one justify a comprehensive ban rather than a ban applicable to the dullards alone?@ (Higgs, 1994, p. 8). But then, who, and on what basis, will select the dullards?

How then does the market protect us? First, suppose we know we are ignorant. If the producer knows more, the development of goodwill (and fear to lose it) of the producer can be an answer. The producer protects us out of self-interest; he wants to see us again, we pay him more. Personal relations can be the solutionCnot the problem. A solution not found in the neoclassical ideal of perfect competition (cp. Wonnell, 1986, p. 522). Second, what about the

standard contracts we just mentioned? Of course, no one has to start from scratch and do all the work himself. But what about weak bargaining power, especially if no standard contracts are available? In a market economy this will never be a problem. As Böhm-Bawerk demonstrated in his article, AControl or Economic Law?@ ([1914] 1962), competition provides an alternative to bargaining: the range of indeterminacy where bargaining is necessary tends to narrow as competition becomes more vigorous (cp. Wonnell, 1986, p. 538). The competitive process protects the weak consumer; his bargaining skills are not that important. Third, the world will change. At this moment A[w]e no longer have a functioning law to encourage and enforce the settlement of accidents beforehand, through deliberate choice, private insurance, and specified compensation or assumption of risk@ (Huber, 1988. p. 222). But this does not mean that the situation cannot change.

But still if society knows less and the government knows more, why not take a short-cut and let the government ban dangerous products right away? In other words, if we possess imperfect information and have a limited capability of processing complex informationCwhich no doubt we haveCwould it not be expedient to let the government ban dangerous products? Is working through markets really necessary? The problem is to decide what will guide the government in its decision making. Next to all sorts of public choice failuresCregulators, for instance, usually assume the worst in each situation (Higgs, 1994, p. 7)Cthere are the already Austrian-noted failures of social cost-benefits analysis. Social aggregation is impossible. Consumers themselves evaluate their welfare and demonstrate it in their actions.

To let an expert choose is no solution. It would mean the end of the market economy. Indeed, some know more than others do. But

A[i]f consumer choice were to be permitted only to consumers whose knowledge, whether of risk or any other dimension, equaled or exceeded that of all other persons, then persons in general would not be permitted to choose anything for themselves, and no genuine market order could exist@ (Higgs, 1994, p. 7). Who determines who knows best, not just of one but of all qualities of a product? Who can give the comprehensive judgment of a good? The market cannot be surpassed. Actions show the preferences and knowledge of the individuals.

Negative externalities: subjectivism and entrepreneurship again

For the sake of the argument, we could say that parties in an exchange can contract all damages between themselves. But what about the innocent bystander: the utter stranger? He certainly cannot; he is no partner in the exchange. As we showed earlier, as far as product liability goes, he is the exception to the rule. It is unnecessary to build our whole system of products liability around him. But still he is the exception we have to look for. In other words, what about negative externalities? For the neoclassical, negative externalities arise because the private and the social net product differ. The normative conclusion follows that with positive or negative externalities, the market leads to sub-optimal results. If externalities are positive, output is less than the Pareto optimal amount. If they are negative, output is greater than it. Through the provision of subsidies or the imposition of taxes, the policy remedy is to try to induce the market to conform to the optimal amounts. The optimal situation is the one that results from a competitive equilibrium in the absence of transaction costs.

Austrians disagree with the Pareto norm of optimality. First, the market is an open-ended process in time. A static, timeless Pareto

optimum is no measure for actual market processes. The market is first and foremost a process, not a state or an institution that facilitates exchange. Second, all costs and benefits are inherently private. It is impossible to say that externalities generate a divergence between private and social costs or benefits. As with all costs, externalities are experienced subjectively; they cannot be added together to arrive at a measurement of social cost (Cordato, 1992, p. 7). Third, the regulator does not have the necessary information to calculate a divergence between social and private costs. If he could get the information without the actual market process, the process of discovery would no longer be needed (cp. Rizzo, 1980, p. 641). But there is no efficient non-market resource allocation. This was the insight the Austrians tried to bring to the fore in the socialist-calculation debate that began with the question AIs an efficient non-market resource allocation possible?@ Market-based prices are necessary to signal scarcity, to transmit knowledge, and to stimulate discovery.

For Austrians, policy relevant externalities are those that involve a conflict of property rights that are not clearly defined or enforced. External costs Aare failures to maintain a fully free market, rather than defects of that market@ (Rothbard, 1962, p. 944). For Mises, all negative externality problems Acould be removed by a reform of the laws concerning liability for damages inflicted and by rescinding the institutional barriers preventing the full operation of private ownership@ (Mises, 1966, p. 658). The problem is that non-owners allocate resources.

Positive externalities do not in general involve a conflict in the use of property. So, for Austrians, positive externalities are not the inversion of negative ones. External benefits are not viewed as either market or institutional failure. They are an unintended benefit of the

market. We cannot conclude that the resulting, prices and quantities are sub-optimal. AThese outcomes simply reflect the freely made decisions of market participants to trade or not to trade under one of an infinite number of cost-benefit relations@ (Cordato, 1992, p. 19). If someone takes an action to his own advantage and a third party benefits, he does not have the right to ask others to subsidize him. In the extreme this will result in the good, such as a public good as consumer information, not being produced at all. Free riders reduce the effective demand almost to zero. For the neoclassical, an excise subsidy must encompass the market output. But, as well as asking that no property rights be violated, the Austrian would ask how much free information is enough before allowing individuals to make their own decisions. Who decides then when consumers are well enough informed?

For the innocent bystander who hasCno doubtCa right to his life and just property, strict liability fits in naturally. The property right is one of integrity for physical violence. Every one has a right to have the physical integrity of his life and property inviolated. No property rights are violated if, for instance, a better and cheaper product comes onto the market. The consumer as well as the producer who possesses the old product cannot ask for any compensation. A[N]o one has the right to protect the value of his property, for that value is purely the reflection of what people are willing to pay for it. That willingness solely depends on how *they* decide to use their money. No one has a right to someone else's money [...]@ (Rothbard, 1982, p. 62). We, however, look at physical violence.

Conclusion

The paperCan exercise in a normative economic analysis of product liabilityChas shown that two tenets of modern Austrianism,

subjectivism and entrepreneurship, can be fulfilled in a system of product liability. Strict liability need not be the Austrian answer. Since people are in contact with each other beforehand, for most product-related accidents, contract law will do. The general rule is buyer and seller beware. If people are not in contact beforehand (the case of the innocent bystander) a wrong, a tort is done, and strict liability is the answer. At no stage in dealing with accidents a third party has to calculate (subjective) costs. At no stage does the market process of discovery (entrepreneurship) have to be stifled.

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