



Stockholm  
University

Department of Economics

**Course name:** Law and Economics  
**Course code:** EC 2105  
**Type of exam:** REGULAR  
**Examiner:** Lars Vahtrik  
**Number of credits:** 7,5 credits  
**Date of exam:** Sunday 24 February 2013  
**Examination time:** 3 hours [14:00-17:00]

**Write your identification number on each paper and cover sheet (the number stated in the upper right hand corner on your exam cover).**

**Use one cover sheet per question.** Explain notions/concepts and symbols. If you think that a question is vaguely formulated, specify the conditions used for solving it. Only legible exams will be marked. Question 4 is a credit question. If you have handed in assignments during the course you

may choose to answer this question anyway if you aim at a higher score. Note that in this case the score on the exam will be counted regardless of your score on the assignments!

**No aids are allowed.**

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The exam consists of 4 questions. Each question is worth 25 points, 100 points in total. For the grade E 45 points are required, for D 50 points, C 60 points, B 75 points and A 90 points.

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Your results will be made available on your "My Studies" account ([www.mitt.su.se](http://www.mitt.su.se)) on Thursday March 14 at the latest.

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**Good luck!**

## Question 1

- a) Explain why very harsh punishment combined with a low detection probability may not be an efficient deterrent for young first time offenders. Suggest a more appropriate deterrence policy for this category of offenders. **(9p)**
- b) Empirical studies seem to suggest that, controlling for other variables, there is a negative correlation between the level of penalty and crime rates. Explain why we still cannot conclude that this observation can be solely attributed to the deterrence effect of higher penalty levels. Kessler & Levitt (1990) claims to have solved the problem of isolating the deterrence effect. In their study they observe a noticeable decline in crime rates comparing the time period immediately before and immediately after immediately after a criminal reform in California involving sentence enhancements for certain eligible crimes. The reform meant that the defendant would receive a five-year increment to his or her incarceration for each prior conviction of a serious felony. Explain the logic behind their claim. Even though the study establishes a significant deterrence effect for the affected group (repeat offenders) from harsher punishment, we cannot conclude that the same is necessarily true for first time offenders. Is there any reason to expect that first time offenders will respond differently to harsher punishment than repeat offenders (apart from the reasons given in your response to question 1a). **(8p)**
- c) Try to explain why a successful attempt to reduce the supply of drugs, by increasing the expected punishment for suppliers, may not be an efficient policy in the short run if your aim is to reduce drug related crimes like violent crimes, robbery and property crimes. Include the response from suppliers, drug addicts and non-addicts to the new policy in your analysis. Is there any reason to believe that the policy could be more effective in the long run? **(8p)**

## Question 2

Consider Hart and More's example with the chef, the skipper and the tycoon. Explain the setup in the example and discuss the consequences of different allocations of ownership of the yacht for the incentives to make relation specific investments that increase the value of the cruise. **(25 p)**

### Question 3

- a) Anton owns a bike that he is emotionally very attached to since it was given to him by his late grandfather. One day it was stolen from him when he had forgotten to lock it when temporarily parking it outside his house. A few weeks later he spots the bike parked and locked at Stockholm University and he calls the police who seizes it. Another student, Ceasar, claims to have bought it from a third student and he can show a receipt and an old ad on blocket. Discuss from an economic perspective whether Ceasar or Anton should be entitled to keep the bike and benefits and disadvantages with different solutions to the dilemma. **(10 p)**
- b) Assume that the relevant court (rightly or wrongly) judge that the bike should be given to Anton. Ceasar buys another bike for twice the amount he paid for Anton's bike to replace the bike he lost. Soon afterwards Ceasar finds the seller of Anton's bike and demands damages from him based on a breach of contract (the seller represented that he owned the bike that he sold). Discuss different models for the seller to compensate Ceasar for the breach of contract and their economic consequences. What remedy, as between Ceasar and the seller, would be the most appropriate in this situation? **(15 p)**

### Question 4 (Credit Question)

An investor can invest in high reliance or low reliance upon the agents future performance. The extra investment in high reliance is made outside the contractual agreement with the agent. The payoffs for the investor and the agent with no enforceable contract are given by

		Agent	
		Perform	Breach
Investor	Invest & low reliance	1 1	-2 2
	Invest & high reliance	1.5 1	-4 2

The agent can appropriate the original investment but not the additional investment. As shown in the matrix the additional investment in high reliance costs 2 which amounts to a total investment of 4. Calculate and explain the meaning of the "tipping point" or critical value of  $p$  (the probability that the agent performs). Show and explain why and when a contract with simple (or naïve) expectation damages may cause an inefficient outcome. Discuss this issue both regarding the investors incentive to invest and the agents incentive to perform. Suggest a solution to the problem and show that your solution guarantees an efficient outcome of the contract. **(25p)**

