



Stockholm
University

Department of Economics

Course name: Law & Economics 1
Course code: EC2105
Type of exam: Main exam
Examiner: Lars Vahtrik
Number of credits: 7,5 credits
Date of exam: Saturday 23 February 2019
Examination time: 3 hours (14:00- 17.00)

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

Start each new question on a new answer sheet.

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.

No aids are allowed.

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.

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 only the score on the exam will be counted regardless of your score on the assignments!

Your results will be made available on your Ladok account (www.student.ladok.se) within 15 working days from the date of the examination.

Good luck!

Question 1

- a) The company Elco emits smoke while producing electricity. The nearby laundry company Clean needs clean air when washing laundry. If there is no smoke Clean will earn a profit of 500 but if there is smoke their profit will be reduced to 300. Elco's profit amounts to 1000. Elco has the option to install scrubbers at a cost of 400 and Clean has the option to install filters at a cost of 100 to stop the smoke from reaching Clean's facility. To complicate matters bargaining is costly. To reach a bargaining solution each company must hire legal expertise to help draft a contract at a cost of 75 each. Should courts use damages or give the laundry company the right to an injunction as default remedy for an infringement on Clean's right to clean air in this case? (Assume that these are the only options available to the court). Discuss the outcome from an efficiency point of view and verify your findings with game theoretical arguments and relevant calculations. **(17 p)**
- b) Will your recommendations remain valid if the cost of legal expertise rises to 175 for each company? Explain and verify your findings. **(8 p)**

Question 2.

- a) Herbert has decided to buy a new car. The salesman shows him a car which he describes as the latest within car technology and Herbert quickly strikes a deal. When he drives home he realizes that the car is not electrified but runs on diesel. Moreover, when he googles the car model he understands that it is several years old and that he could have bought it much cheaper at another car dealer. Lastly, when he parks in front of his home and closes the car door, the car window suddenly crashes down on the ground and breaks. Herbert knows that the main principle of contract law is that agreements should be enforceable, but he wonders if there are any exceptions in this case. Please discuss from an economic viewpoint if there should be any mandatory laws making the agreement unenforceable. **(10 p)**
- b) If the agreement is enforceable, there could still be circumstances giving Herbert right to damages due to breach of contract. Please explain how the damages can be structured to provide Herbert an economically efficient protection if there is a breach of contract in this situation. **(5 p)**
- c) Herbert and the car dealer cannot agree. Herbert has heard that it can take a very long time to go to court and that it might be expensive. The car dealer suggests arbitration as an alternative. Please explain the difference between public courts and arbitration and the economic benefits with the different dispute resolutions. Discuss if there might be a better form of legal proceeding to solve this dispute. **(10p)**

Question 3

Consider an investor and an entrepreneur that can enter a business relationship where the investor invests 100 and where the joint profit of the investment amounts to 50 each in case the entrepreneur performs. In case the entrepreneur breaches the contract the investor gets -100 and the entrepreneur gets 100 (without damages). In addition our investor can make an additional investment with a third party of 80. If the entrepreneur performs our investor will increase the profit from 50 to 70 by making the extra investment and our entrepreneur still receives 50. In case of breach the extra investment yields a payoff of -180 to the investor and 100 to the entrepreneur (without a contract). Will naïve expectation damages give the investor optimal incentives to invest in reliance? Explain and show, with the help of relevant calculations, how a correct interpretation of perfect expectation damages can solve the problem of optimal reliance in this case. **(25p)**

Question 4 (Credit Question)

- a) Explain why harsh punishment combined with 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. **(9 p)**
- b) Try to explain why an attempt to reduce the supply of drugs, by increasing efforts to apprehend and convict drug dealers, 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 as well as the use of drugs. Back your reasoning with suitable diagrams. Compare this policy, in the short run and in the long run, with a policy that combines an effort to reduce supply on the open market with a policy of selling subsidised prescription drugs to registered drug addicts. **(9 p)**
- c) Large sums are spent on private investments in burglar alarms. Discuss if there is an efficiency argument for subsidising private investments in alarms if:
- i) the alarm is hidden and silent
 - ii) the alarm is clearly visible from the outside. **(7 p)**