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August 5, 1981

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Timothy J. Muris, Esquire
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Dear Tim:

Pursuant to our telephone conversation this afternoon, I am sending you an economic analysis of certain product liability issues prepared by Dick Posner for the Ford Motor Company. One of the enclosures is a brief summary of the other. This analysis should be useful in the White House's deliberations regarding possible federal legislative approaches to address the product liability crisis.

As you will see upon review of the paper, Dick analyzed issues, such as federalism, government regulation, punitive damages and driver misconduct, from the standpoint of economic theory. Posner's conclusions are his own, and there are clearly individual points to which Ford Motor Company, for business or other reasons, would not subscribe (for example, elimination of all motor vehicle regulations). But, in general, we believe the paper presents a cogent economic rationale for changing federal law and adopting a rational and balanced approach to the law of product liability.

Timothy J. Muris, Esquire
August 5, 1981
Page Two

After you have had a chance to read these papers, I look forward to discussing them with you and others in the Executive Office who will be working on this issue. Please let me know who they will be.

Sincerely,



Calvin J. Collier

Enclosure

ECONOMIC ANALYSIS OF THE NEED FOR FEDERAL
LEGISLATION TO LIMIT STATE PRODUCTS LIABILITY
LAW AND FOR AMENDMENTS TO THE NATIONAL
TRAFFIC AND MOTOR VEHICLE SAFETY ACT OF 1966

Richard A. Posner
Lexecon Inc.

The National Traffic and Motor Vehicle Safety Act of 1966 empowers the National Highway Transportation Safety Administration (NHTSA) to promulgate Federal Motor Vehicle Safety Standards and forbids states to enact standards applicable to the same aspect of vehicle performance as is covered by an FMVSS. The Act also provides, however, that "Compliance with [an FMVSS] does not exempt any person from any liability under common law." As a result, in products liability cases charging vehicle manufacturers with unsafe design, defendants are regularly held liable for design choices that complied with the federal standards. This paper considers economic reasons for amending the Act to make compliance with a federal safety standard a complete defense in any products liability case under state law.

Part I is a general introduction to the economic analysis of products liability law. It shows that in at least five areas current state law is in serious conflict with the dictates of economic efficiency. First, the law disregards consumer choice by refusing to recognize compliance with the industry standard of care as a defense in design-defect cases. The Coase theorem teaches--what is only common sense--that where parties are in a direct or indirect contractual relationship, the market will bring about the level of

product safety (and of product quality and price) that maximizes consumer welfare. Sellers whose products are below the safety standard that consumers desire and are willing to pay for will lose sales to those whose safety conduct meets consumers' desires. When an entire industry adheres to a particular custom in regard to safety, the inference is compelling that this is the standard consumers desire, for if they did not desire it then some firms would adopt a different standard.

(Second,) contemporary products liability law often fails to recognize a defense of unsafe use by the consumer. But it is elementary economics, and again simple common sense, that if a product accident can be avoided at lower cost by the user than by the maker, the user should not be encouraged to forgo the most effective method of accident avoidance by being compensated for any and all losses.

(Third,) liability is often imposed in products cases where the product is defective by current safety standards but not by the standards recognized when the product is made. Yet not only can retroactive liability have no positive effect on safety--a manufacturer cannot make his product safer after he has designed, produced, and sold it--but it can have a negative effect. It can lead manufacturers to make their products less durable--more fragile--in order to reduce the stock of product to which a retroactive liability standard might some day be applied. And it can discourage manufacturers from introducing new safety technology, since

they know that the technology will set a new safety standard that, applied retroactively to products they made under an earlier technology, will increase their costs.

Fourth, punitive damages are often imposed in product cases. They should not be. Among other things, they may make manufacturers take too many safety precautions--and consumers too few. Since by definition the consumer who receives an award of punitive as well as compensatory damages is overcompensated, his incentive to avoid being injured is reduced by the prospect of such an award. Moreover, economic analysis decisively refutes the notion that a product defect is an intentional wrong just because the manufacturer who produces a large output knows, with a confidence approaching certainty, that some of his output will be deemed defective and lead to accidents. In economic analysis, the category of intentional misconduct is reserved for cases where there is a tremendous disparity between the costs and benefits of avoiding injury. In nearly all product cases, there is no great disparity between the costs and benefits of accident avoidance. For example, the cost per sale of some product of avoiding an accident might be \$10 and the benefit of avoidance (which is equal to the expected accident cost) might be \$12. The cost-benefit ratio would thus be 5 to 6. It is not changed if, because the manufacturer of the product in question has a large output, the total costs of accident avoidance are \$10,000 and the total benefits \$12,000.

Increasing the scale of the producer's activity does not transform accidental into intentional conduct.

Fifth, even clear and conspicuous disclaimers of product liability usually are not enforced by the court. This is an economic mistake. This conclusion is a simple application of the Coase theorem, discussed earlier. If a seller and a buyer freely consent to a lower than standard safety level for the product in question, expressing this consent in a clear and conspicuous disclaimer by the seller (for which he presumably compensated the buyer by offering him a lower price or a higher quality of product), then consumer welfare is maximized by enforcing the disclaimer.

Against this background, Part II of the paper considers whether the specific amendment to the National Traffic and Motor Vehicle Act of 1966 that is the focus of the paper is responsive to the economic criticisms in Part I, under the assumption (relaxed in Part III) that there is no concern with the possible impact of the amendment on the balance of power between the states and the federal government.

First of all, from an economic standpoint the Act is hopelessly contradictory in preempting state legislative prescription of safety standards overlapping the federal standards but in failing to preempt state judicial prescription of such safety standards. The economic analysis of tort law treats that law, functionally rather than formalistically, as regulatory law, just like legislation. The regulatory feature is highlighted by the increasingly frequent award of

punitive damages in products cases. To an economist, punitive damages are the equivalent of a fine--the usual sanction for violation of a legislated safety standard. Legislative and judicial safety standards are economically equivalent and if one type is preempted by the federal Act so should the other be.

Second, given that NHTSA incurs the costs of promulgating safety standards, the overall costs of government regulation are minimized by giving those standards conclusive effect in products liability cases to which they are relevant. The entire and very considerable expense of determining design-defect questions in products liability cases is wasted from a social standpoint wherever there is an applicable federal safety standard which could be used to answer the question at zero incremental social cost; since the standard will already have been promulgated, there is no added cost to applying it in a products liability case.

Third, since, as shown in Part I, the Coase theorem teaches that industry design standards are probably optimal without any legal intervention at all, it is hardly likely that efficiency is promoted by imposing standards stiffer than the federal safety standards. There is too much regulation of design questions already and to allow state judicial regulation to be piled on top of federal administrative regulation is clearly to move in the wrong direction.

To all these points it may be replied that the economist is overlooking the claims of federalism, which argue

for giving the states a larger, not smaller, role in the regulation of products. [Part III discusses these claims and shows why the amendment would promote rather than impair an economically rational division of functions between the states and the federal government. A state which imposes drastic safety standards in vehicle product liability cases thereby increases the cost of automobiles not only to the residents and voters of the state, but also to the residents of other states, since the vehicle manufacturers cannot feasibly respond to idiosyncratic state liability rules by safety "add-ons" (comparable to emission controls) limited to vehicles sold in that states, or by simply charging a higher vehicle price in that state (which would induce people to buy their cars in other states). Hence state products liability law, which by a loophole is not preempted by federal vehicle safety regulation, allows states to impose costs on people who have no political power in the state--i.e., on consumers, workers, and stockholders in other states. This is a formula for abuse--a new variant of "taxation without representation." It is much the same (in economic analysis) as if a state imposed a tariff on goods imported from other states. The tariff would impose costs on people out of state as well as on local consumers--and would clearly violate the Commerce Clause of the Constitution.]

Unrestricted state products liability law also has consequences for the competitiveness of U.S. automobile manufacturers vis-a-vis Japanese and other foreign manufac-

turers both in the U.S. and foreign markets. Because a U.S. automobile manufacturer will invariably sell a much higher percentage of its output in the U.S. than a foreign manufacturer will sell of its output in the U.S., the "tax" that is imposed on all sellers of cars in the U.S. by virtue of state products liability rulings affects a larger part of the output of the U.S. manufacturers than of the foreign manufacturer. To the extent that U.S. manufacturers cannot segment their markets, and "collect" this tax in higher vehicle prices in the U.S. alone, the higher costs of doing business for the U.S. manufacturer due to the product liability "tax" will be felt all over the world, will be higher than the costs of the foreign manufacturers due to the same tax, and will therefore reduce the competitiveness of U.S. manufacturers both at home and abroad.

In any event, the proposed amendment is not an effort to displace state with federal regulation. The federal regulation exists; the overall burdens of government regulation will be reduced by not allowing the state courts to pile additional regulation on top of existing federal regulation.

ECONOMIC ANALYSIS OF THE NEED FOR FEDERAL
LEGISLATION TO LIMIT STATE PRODUCTS LIABILITY
LAW AND FOR AMENDMENTS TO THE NATIONAL
TRAFFIC AND MOTOR VEHICLE SAFETY ACT OF 1966

Richard A. Posner
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Part I is a general introduction to the economic analysis of products liability law. It shows that current state law is in serious conflict with the dictates of economic efficiency. Against this background, Part II considers why the specific amendment to the National Traffic and Motor Vehicle Act of 1966 that is the focus of the paper is responsive to the economic criticisms in Part I, under the assumption (relaxed in Part III) that there is no concern with the possible

impact of the amendment on the balance of power between the states and the federal government. Part III discusses this impact and shows why the amendment would promote rather than impair an economically rational division of functions between the states and the federal government.

I.

The economics of "nonmarket behavior" has made long strides in recent years.¹ One subject studied extensively by this branch of economics is the regulation of safety, both directly through safety legislation and indirectly through the tort system.² Products liability law has been an

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1. For an introduction to this field of economics see Gary S. Becker, *The Economic Approach to Human Behavior*, Ch. 1 (1976); Richard A. Posner, *The Economics of Justice*, Ch. 1 (1981).
 2. On direct safety regulation see, e.g., Richard J. Arnould & Henry Grabowski, *Auto Safety Regulation: An Analysis of Market Failure*, 12 *Bell. J. Econ.* 27 (1981); Nina W. Cornell, Roger G. Noll & Barry Weingast, *Safety Regulation*, in *Setting National Priorities: The Next Ten Years*, 457 (Henry Owen & Charles L. Schultze eds. 1976); Howard P. Marvel, *Factory Regulation: A Reinterpretation of Early English Experience*, 20 *J. Law & Econ.* 379 (1977); Sam Peltzman, *An Evaluation of Consumer Protection Legislation: The 1962 Drug Amendments*, 81 *J. Pol. Econ.* 1049 (1973); Sam Peltzman, *The Effects of Automobile Safety Regulation*, 83 *J. Pol. Econ.* 677 (1975); Paul E. Sands, *How Effective Is Safety Legislation?*, 11 *J. Law & Econ.* 165 (1968). On liability rules see, e.g., John Prather Brown, *Toward an Economic Theory of Liability*, 2 *J. Legal Stud.* 323 (1973); Guido Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* (1970); Peter A. Diamond, *Single Activity Accidents*, 3

important component of the economic analysis of safety regulation.³

The economic literature on liability rules is diverse. Some economists (including lawyer-economists such as Guido

Footnote 2 continued

J. Legal Stud. 107 (1974); Peter A. Diamond, Accident Law and Resource Allocation, 5 Bell J. Econ. & Mgmt. Sci. 366 (1974); Jerry Green, On the Optimal Structure of Liability Laws, 7 Bell J. Econ. & Mgmt. Sci. 553 (1976); William M. Landes & Richard A. Posner, Joint and Multiple Tortfeasors: An Economic Analysis, 9 J. Legal Stud. 517 (1980); Richard A. Posner, A Theory of Negligence, 1 J. Legal Stud. 29 (1972); Steven Shavell, Strict Liability versus Negligence, 3 Legal Stud. 1 (1980); Steven Shavell, An Analysis of Causation and the Scope of Liability in the Law of Torts, 9 J. Legal Stud. 463 (1980); The Economics of Medical Malpractice (Simon Rottenberg ed. 1978). There are chapter-length discussions of the economics of liability rules in two textbooks on economic analysis of law. See Werner Z. Hirsch, Law and Economics: An Introductory Analysis, Ch. VII; Richard A. Posner, Economic Analysis of Law, ch. 6 (2d ed. 1977). Posner also discusses briefly the direct regulation of safety and health. See *id.* at 276-78.

3. See, e.g., James N. Buchanan, In Defense of Caveat Emptor, 38 U. Chi. L. Rev. 64 (1970); Victor P. Goldberg, The Economics of Product Safety and Imperfect Information, 5 Bell J. Econ. & Mgmt. Sci. 683 (1974); Koichi Hamada, Liability Rules and Income Distribution in Product Liability, 66 Am. Econ. Rev. 228 (1976); Roland N. McKean, Products Liability: Implications of Some Changing Property Rights, 84 Q.J. Econ. 611 (1970); Walter Y. Oi, The Economics of Product Safety, 4 Bell J. Econ. & Mgmt. Sci. 3 (1973); Janusz A. Ordover, Products Liability in Markets with Heterogeneous Consumers, 8 J. Legal Stud. 505 (1979); Richard A. Posner, Economic Analysis of Law 134-37 (2d ed. 1977); Marilyn J. Simon, Imperfect Information, Costly Litigation, and Product Quality, 12 Bell J. Econ. 171 (1981); A. Michael Spence, Consumer Misperceptions, Product Failure and Producer Liability, 44 Rev. Econ. Stud. 561 (1977).

Calabresi) criticize the traditional negligence, or fault, system as an inefficient system of accident control.⁴ Others believe the fault system, at least as traditionally understood (an important qualification, as will appear), approximates an optimal system of accident control.⁵ Some economists think the optimal liability rule in product cases would be no liability (caveat emptor);⁶ others that seller liability in some form or other is better.⁷

But most economists who have studied the safety-liability area would probably agree on the following propositions concerning an efficient system of tort liability for injuries caused (or aggravated) by product defects or attributes:

1. Compliance with industry custom should be an absolute defense to liability in any case where the accident victim is a user of the product (as distinct from a bystander-- the importance of this distinction will become clear). This

4. See, e.g., Calabresi, supra note 2, at pt. IV.

5. See, e.g., William M. Landes & Richard A. Posner, The Positive Economic Theory of Tort Law (forthcoming in Georgia Law Review).

6. See, e.g., Buchanan, supra note 3.

7. For a rather extreme position (no disclaimers of liability should be enforced) see Ordover, supra note 3; and note 22 infra.

is an implication of the "Coase theorem."⁸ This theorem states that when transaction costs (i.e., the costs of making and enforcing an agreement) are zero, the efficiency of resource use will be unaffected by the law's choice of liability rules. To illustrate, suppose the cost to manufacturer A of some safety improvement in his product is \$10, and the benefit in greater product safety--or, stated differently, the expected accident cost that the safety improvement will avert--to the consumer, B, is \$11.⁹ If the rule is no

8. See Ronald H. Coase, *The Problem of Social Cost*, 3 *J. Law & Econ.* 1 (1960); and for a simple exposition of the theorem Posner, *supra* note 3, at 35-36. There is a large and contentious literature on the Coase theorem, though its basic validity is conceded and the relevant limitations of the theorem are acknowledged in this memo. For samples of the literature see Peter H. Greenwood & Charles A. Ingene, *Uncertain Externalities, Liability Rules, and Resource Allocation*, 68 *Am. Econ. Rev.* 300 (1978); Varouj A. Aivazian & Jeffrey L. Callen, *The Coase Theorem and the Empty Core*, 24 *J. Law & Econ.* 175 (1981); Ronald H. Coase, *The Coase Theorem and the Empty Core: A Comment*, 24 *J. Law & Econ.* 183 (1981).

9. "Expected accident cost" is the cost of the accident if it occurs times the probability that it will occur; e.g., the expected accident cost of a .022 probability of a \$1000 accident is \$22. A product safety improvement that reduces the probability that an accident will occur from .022 to .011 will reduce expected accident losses by \$11 (= (.022 - .011) x \$1000). This is a measure of the social benefit of a design change or other measure that will reduce the likelihood of the accident's occurring. Similarly, a safety improvement that does not affect the probability of an accident, but reduces the loss from a given accident from say \$1000 to \$500, has an expected value of \$11 = (.022 x (\$1000 - \$500)). We abstract from the complications introduced by assuming that victims or injurers are risk averse rather than risk neutral; only if risk neutrality is assumed is the expected accident cost as we have defined it an accurate measure of the utility of a safety improvement that will avert the cost. But these com-

liability, A will still have an incentive to adopt the safety improvement because he will be able to raise his price by something between \$10 and \$11. To see this, suppose the product without the safety improvement could be sold to B for no more than \$100. This implies that the product was worth \$122 to B, for remember that before the safety improvement he incurs an expected accident cost of \$22 to use it. Reduce that expected cost by \$11 and he will be willing to pay up to \$11 more. Therefore if A charges a price anywhere between \$110 and \$111, both parties to the transaction, A and B, will be better off. A therefore has a strong incentive to adopt the safety improvement even if he is not liable for an accident that the improvement could have prevented.¹⁰

Now assume that instead of no liability the rule is strict liability: if A doesn't install the safety improvement, his product will be deemed defective and he will have to pay damages of \$1000 if an accident occurs. He again has an incentive to adopt the improvement since the savings to him in expected costs of liability, \$11, are greater than the

[Footnote 9 continued]

plications would not alter our analysis in any material respect. Nor is it important that we assume a single possible accident loss, rather than treating this as the weighted average of many different possible accident losses with associated probabilities.

10. We abstract from possible complications, which again would not affect our analytical point, deriving from the fact that the industry may be more or less competitive and consumers may vary in their aversion to risk or their ability to protect themselves against a less safe product.

cost of the improvement, \$10. So the choice of the liability rule makes no difference to the ultimate allocation of resources: the improvement is adopted.

Now reverse the numbers. Assume the safety improvement costs \$11, and the expected accident costs which it will avert are only \$10. If the rule is no liability, the improvement will not be adopted, because there is no price increase that will cover the cost of the improvement and still make both parties better off. The same thing is true if the rule is strict liability. For A would rather bear an expected liability cost of \$10 than pay \$11 to eliminate that expected cost. Again the choice of the rule of liability doesn't matter. This is the essential teaching of the Coase theorem.

Of course the assumptions underlying the analysis are severe; but it is nonetheless highly pertinent. The transaction costs between a manufacturer and a consumer of his products are not zero but they are low, so the Coase theorem should hold in the products area as an approximation. That is, if there are cost-justified product safety devices, the firms in an industry will have a strong incentive to adopt them in order to make more profits by giving consumers greater value for their money. Probably this incentive is especially strong if the industry is competitive.¹¹

11. If a monopolist mistakenly fails to adopt some cost-justified safety device, this mistake may not be corrected as quickly as it would be in a competitive industry, where firms that make mistakes quickly lose sales to firms that don't. On the other hand, a monopo-

This type of argument has persuaded some economists that the appropriate liability rule in product cases (always excepting product cases in which the victim is a bystander, for unlike a consumer a bystander is not in an actual, or realistically potential, contractual relationship with the manufacturer) is no liability. The law need not intervene in the products liability area at all, because there are adequate market incentives, described above, to ensure an efficient allocation of resources to safety. I do not push the argument so far. Given the complexity of modern products, it is possible that such a rule would leave the consumer unprotected against the manufacturer who provided a substandard product without warning to the consumer. (If the consumer is warned, then presumably he will not buy the product unless given an appropriate discount. And if he is given a discount, there is no clear economic basis for liability should he be injured because the product is below the usual standard of safety for products of this type: he was compensated for bearing that risk.) But the argument from market incentives does make a convincing case for recognizing a

Footnote 11 continued

list can capture more of the gain from an improvement in his product than a firm in a highly competitive industry, so he has a greater incentive to make improvements. Perhaps, though this is conjecture, the optimal industry structure, so far as encouraging cost-justified safety improvements is concerned, is oligopoly--and of course many if not most consumer products are produced by oligopolistic industries. See Morton I. Kamien and Nancy L. Schwartz, Market Structure and Innovation: A Survey, 13 J. Econ. Lit. 1 (1975).

defense in a products liability suit of compliance with the customary standard of care in the industry. It is not economically plausible to imagine that a safety device which a majority of the members of a competitive industry have not seen fit to adopt is nonetheless in the best interest of consumers.

2. If the victim is the "cheaper cost avoider" of an accident, the injurer should not be liable for the consequences of the accident. Imagine a case where the cost to the manufacturer of reducing the likelihood of an accident by some change in the design of his product is \$10, and the reduction in expected accident cost is \$15. It may seem that the product is therefore defective in an economic sense if the safety improvement is not made. But this inference would be incorrect if the \$15 expected accident cost could be avoided by the consumer's spending less than \$10 on reducing the likelihood of the accident. He might, for example, be able to reduce it at a cost (say, in time lost by driving more slowly, if the product was a car) of \$8. In that event, consumer welfare is maximized by a finding of no liability, since such an outcome will give consumers as a group an incentive to spend \$8 on care. The alternative is for the manufacturer to spend \$10 and raise his price by (as a rough approximation) \$10 to cover his added cost.¹² The consumer is better off by \$2 if he avoids the accident himself.

12. Of course, a manufacturer may not be able to pass on the whole of a cost increase to consumers in the form

The noneconomist may think that it is unrealistic to suppose that consumers would be induced to take greater care by the threat of being denied tort compensation if they failed to do so and were hurt. But the economist regularly assumes, and with much evidence to back him up, that individuals do respond, often in surprisingly subtle ways, to economic incentives, even in respect to such seemingly emotional aspects of living as behavior toward safety.¹³ Of the many studies that support this point, three are of especial relevance here. One is the study by Thaler and Rosen which found that workers in dangerous jobs demand and receive risk premiums.¹⁴ Another is a study by Grayson which found that a more highly differentiated liability insurance scheme results in a lower accident rate than one with less differen-

[Footnote 12 continued]

of a higher price for his product; under some conditions, he will not be able to pass on any part of it. But it is unimportant who bears the extra \$2 cost that is imposed if the consumer lacks an incentive to take the \$8 precaution; it is a deadweight loss to society no matter who bears it.

13. For some striking evidence with regard to the response of potential criminals to changes in the severity of criminal sanctions or the probability of punishment see Isaac Ehrlich, *Participation in Illegitimate Activities: An Economic Analysis*, in *Essays in the Economics of Crime and Punishment* 68 (Gary S. Becker & William M. Landes eds. 1974).
14. See Richard Thaler & Sherwin Rosen, *The Value of Saving a Life: Evidence from the Labor Market*, in *Household Production and Consumption* 265 (Nestor J. Terleckyj ed. 1975).

tiation.¹⁵ The more finely calibrated schemes place more of the costs of accidents on the more dangerous drivers, and this added cost has a deterrent effect; for example, fewer parents let their kids drive when premiums are much stiffer for accident-prone drivers such as young males. The third study, by Elisabeth Landes, found that the adoption of a no-fault auto compensation system by a state increases the accident rate; the curtailment of tort liability (which is one aspect of no-fault) results in more careless driving, and so a higher accident rate.¹⁶

These are econometric studies in which the authors use statistical methods to correct for other factors, besides the variable whose effect they are interested in measuring (the danger of an occupation, the fineness of the insurance classifications, or the presence or absence of no-fault). Statistical methods to simulate controlled experiments have many limitations and the above studies should not be regarded as conclusive. But together with the many other studies that show that people are rational calculators of their self-interest (much of the calculation unconscious, to be sure) in nonmarket as well as market behavior, they provide

15. See Richard W. Grayson, Deterrence in Automobile Liability Insurance (unpublished Ph.D thesis, University of Chicago, Graduate School of Business, 1971).

16. See Elisabeth M. Landes, Insurance, Liability and Accidents: A Theoretical and Empirical Investigation of the Effect of No-Fault on Accidents (University of Chicago, Center for the Study of the Economy and the State, 1980).

persuasive evidence that a defense based on plaintiff's conduct (whether called misuse or mishandling or assumption of risk or contributory negligence) that shifts liability to the plaintiff when he is the cheaper cost avoider will reduce accidents and accident-avoidance costs.

The arguments presented in this and the previous section suggest that a negligence rule (with contributory negligence) is the appropriate one for products liability cases, with the standard of care required of the producer being determined by industry custom. The economic theory of torts prefers negligence rules where, as in most products cases, both the potential injurer and the potential victim can invest resources in reducing accident losses.¹⁷ Assume, for example, that proper use of a product will reduce losses from an injury in the event an accident occurs by \$2, at a cost of \$1 to the user, and that this will be true even when the manufacturer adopts a \$10 safety improvement (because this improvement reduces expected losses from an accident but does not eliminate them). A rule of strict liability will cause the producer to adopt the safety improvement as discussed above. However, because under a strict liability rule the manufacturer fully compensates the victim for any accident losses, the user's incentive to invest his own dollar of resources in careful use of the product is eliminated, and he will not take proper care. As a result, there will be more accidents, and

17. See Landes and Posner, supra note 5.

injury losses will be greater than if he had taken that care.

This problem can be overcome by the use of a negligence rule. The fear of tort liability unless the due care standard is met will induce producers to comply with the standard. Similarly, lack of compensation to consumers if producers comply with the standard will induce consumers to take the appropriate amount of care in using the product. Thus, if the standard of care is the efficiency or cost-minimizing standard, a negligence rule leads to the economically desirable outcome. The argument above shows that this optimal standard of care should be industry custom.

3. Liability should be imposed in a products case only where the product is defective as judged by the customs or standards of the industry when the product was manufactured. If a product complied with the customary safety standards of the industry when made in 1975, the fact that in 1981 those standards have risen because of new technology or some other factor is immaterial and evidence concerning the current standard should be excluded. The economic approach is forward-looking. The economist views liability not as a device for redistributing wealth but as a method of inducing producers and consumers to be more careful in the future.¹⁸ Where liability will have no effect on future behavior because the producer could not have complied with the legal

18. See, e.g., Posner, supra note 3, at 18-19.

rule when he made the product, imposing liability has no economic function.

Moreover, retroactive liability may have two perverse effects: inducing manufacturers to make their products less durable and delaying the rate at which safety technology is adopted. Reducing durability minimizes expected future liability costs by reducing, on any given future date, the amount of the manufacturer's output equipped with "old-standard" safety devices. The second effect may arise because, for a given level of durability of the stock of old products, although adopting new safety improvements reduces the expected accident and liability costs for new products, it raises expected liability costs for old ones by raising the liability standard that will be applied to them. Therefore, if the rule is that current safety standards will be applied to products produced in the past, the cost to the producer of adopting a safety improvement may rise and the improvement may not be adopted even if it is socially cost-justified.

4. Punitive damages should not be awarded in a products liability case.¹⁹ The economist begins his analysis of damages with the presumption that compensatory damages are

19. The whole subject of the proper role of punitive damages in tort cases is considered in a recent article. See William M. Landes & Richard A. Posner, An Economic Theory of Intentional Torts, forthcoming in International Review of Law and Economics. An earlier version of this paper is available as Working Paper No. 5 of the Law and Economics Program of the University of Chicago Law School, Feb. 23, 1981.

the proper measure of damages in an accident case and punitive damages decidedly exceptional. Go back to the case first put where the cost of reducing the likelihood of an accident through adopting some safety improvement was \$10 and the expected accident cost that the improvement would avert was \$11, the latter consisting of a .011 reduction in the chance of an accident that would cost the victim \$1000. If the manufacturer does not adopt the improvement, and the accident occurs, the proper measure of damages is \$1000, i.e., simple compensatory damages. That amount will give manufacturers adequate incentives to adopt cost-justified safety improvements. Any greater amount may well result in a misallocation of resources. The danger of misallocation arises from four separate factors: legal error, the strict liability character of products liability, the uncertainty of care or accident avoidance, and the effect on the incentives of victims to take care.

To illustrate the first factor, suppose that some safety improvement that would avert an expected accident cost of \$10 would cost \$11, but a court, mistaking the costs and benefits, concludes that failure to adopt it makes the product defective and the company liable if an accident occurs. If only compensatory damages are awarded, the error is harmless; as pointed out in our discussion of the Coase theorem, the company will prefer to incur the costs of liability rather than adopt the more costly improvement. But now suppose that the company can anticipate being forced

to pay punitive as well as compensatory damages. Suppose it thought it might be forced to pay on average 20 percent above its compensatory damages in punitive damages. Then the judgment it can expect to pay if it does not adopt the safety improvement and an accident occurs is not \$1000 but \$1200, and hence the expected judgment cost is \$12 rather than \$10. The firm may be induced to adopt a socially inefficient safety measure.

Punitive damages may bring about this result even if the legal system operates without making any errors. Suppose there is some defect in a component which the manufacturer of the final product could not discover at reasonable cost; he would nevertheless be strictly liable for the consequences of the defect (this is in fact the principal difference between a negligence and a strict liability standard in product cases). As before, the expected accident cost might be \$10 and the cost of an inspection that would discover the defect might be \$11. If punitive damages are awarded and they bring the expected judgment cost above \$11, the manufacturer will be induced to make the inspection even though it is not cost-justified to do so.

There is the further fact that taking care can only reduce, and not completely eliminate, the probability of an accident. It could be that to reduce the probability of some defect with an expected accident cost of \$10 to zero would cost \$11, and so would not pay in a social sense. But the legal system, looking only at the average cost of avoidance

(which might be much lower, say, \$2), would judge the product defective and hold the manufacturer liable. Again, if punitive damages are awarded, the manufacturer may be induced to take excessive safety precautions.

Finally, the expectation of punitive damages reduces the consumer's incentive to take proper care in using the product. In fact, it encourages unsafe use, since the accident victim may expect to be overcompensated for his loss. Thus, punitive damages may not result in fewer accidents or lower accident costs. On the contrary, increased unsafe use by consumers may overwhelm any incentive to greater safety in design and actually lead to more accidents and higher accident losses.

Another force tending in this direction is the change in relative price between new products with excessive safety devices due to punitive damages and older ones without these devices. (The award of punitive damages in products cases is recent.) Since by definition the term "excessive safety" means that the cost is greater than the consumer benefit, the real price of the newer products will rise relative to that of the older products and consumers will be induced to continue using the older, less safe products rather than to purchase the newer, safer ones for which manufacturers have adopted the more stringent safety standards that the threat of punitive damages induces.

All this is not to say that punitive damages should never be awarded, but they are properly reserved for two

types of case. One is where the injury is concealed, so that injurers get away with some significant fraction of the accidents they cause.²⁰ For example, if the expected accident cost of some dangerous practice is \$20 ($.02 \times \1000) and the avoidance cost \$10, but injurers are discovered only in 10 percent of cases, then potential injurers, if they are liable only for compensatory damages, will reckon their expected liability costs as only \$2 (because they pay a judgment in only 10 percent of the cases) and they will not avoid the accident even though it is socially cost-justified to do so. In such a case the proper measure of damages is the expected accident cost divided by the probability that the injurer will be brought to bar. That is, it is $\$1000 \div .10 = \$10,000$, of which \$9,000 would be punitive and \$1000 actual damages. But concealment is not a serious problem in the products liability area, at least nowadays, when every serious automobile accident is carefully studied by engineers and lawyers for evidence of a product defect.

The second reason for awarding punitive damages is when there is a great disparity, favoring avoidance, between the expected injury and the costs of avoidance. In some cases, indeed, the expected injury costs are a large positive number and the costs of avoidance are negative. Suppose A murders B. What is the social cost to A of avoiding this

20. This point is emphasized in Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1976).

injury? It is not a positive cost, as driving carefully is a positive cost; it requires no expenditure of time or energy. On the contrary, it is a negative cost, because A saves time and energy by not murdering B. The expected injury cost might be \$1 million (1 x \$1 million), and the costs of avoidance -\$100. With this tremendous disparity between the costs and the benefits of avoiding injury (also present in certain cases of recklessness, as where a driver while driving down a busy street closes his eyes in order to rest his eyelids: the expected accident costs might be enormous; the costs of accident avoidance--of keeping his eyes open--are trivial), we have little reason to fear that punitive damages will cause the misallocations discussed above. And they will serve the valuable function, among others, of increasing the incentives of victims to invoke the legal process against seriously antisocial conduct.

Great disparities between costs of avoidance and expected accident costs are rarely found in products liability cases. One would not need a rule of strict liability, or even negligence, to deal with cases of great disparity. Hence, rarely if ever should punitive damages be awarded in a products liability case.

Moreover, while punitive damages are often and properly awarded in cases of intentional wrongdoing, as in our murder example, economic analysis helps to show why injuries caused by defective products are not "intentional" even though the scale of the manufacturer's activity may be such that he knows

with a confidence approaching certainty that his product will cause a number of serious or even fatal accidents every year. In the murder case above--a typical intentional-wrongdoing case--there was a high probability of injury (indeed I assumed a probability of 1), conjoined with a very low (in that case actually negative) cost of avoiding the injury; it is in such circumstances that we properly infer from the circumstances that the defendant was intending to harm the plaintiff. But where expected accident costs and accident avoidance costs are not greatly disparate, the mere scale of the activity in which the potential injurer is engaged does not make them so. If the cost of some safety improvement is \$10 per vehicle, and the expected accident cost per vehicle which that improvement will avoid is \$11, it is a simple negligence case (because the costs and benefits of the improvement are close to each other) and is not changed by the fact that the manufacturer produces 100,000 such vehicles. The total costs of the safety improvement are now \$1 million and the total benefits \$1.1 million, but the ratio of costs to benefits is unchanged. If there is no intentional wrongdoing in the case of the single vehicle there is none when a large number of vehicles are produced.²¹

21. This is easily shown using what is now the standard model of accident costs and accident avoidance. Let $L(x,y)$ be the expected accident costs per potential victim, as in

$$L(x,y) = p(x,y)D + A(x) + B(y),$$

5. Disclaimers of liability should be enforced when clear and conspicuous. This proposition is derived directly from the Coase theorem. A disclaimer is simply a way of communicating to the consumer that a lower standard of care than he might otherwise expect has been used in the manufacture of the product in question. For example, a manufacturer of tires might disclaim liability, whether for personal injury or property damage, resulting from a blow-out after the tires were used for 10,000 miles. This tells the consumer that the tires are not built for assured safety in longer use. Presumably the consumer will not buy these tires, knowing this fact, unless he is compensated in the form of a lower price. The qualification that the disclaimer be clear and conspicuous is a crucial one, since if it is not there can be no assurance that the actual level of safety built

[Footnote 21 continued]

Where $p(x,y)$ is the probability of an accident, D is the resulting damage to the victim, A , x and y are the inputs of care of victim A and the injurer, B , respectively, and $A(x)$ and $B(y)$ are the costs of care to A and B respectively. Assume for simplicity that A can do nothing to avoid the accident, so that his optimal expenditure on care is zero. Then the above equation simplifies to

$$L(y) = p(y)D + B(y).$$

We can find the optimal y , which we call y^* , by differentiating L with respect to y and setting the resulting expression equal to zero. This yields the following formula for the injurer's optimal expenditure on care, B_y :

$$B_y = -p_y D.$$

(We assume that the second-order conditions for a minimum are satisfied and, as before, that the parties are risk neutral; these assumptions do not affect the point we are making here.)

into the product is also the bargained level. But if it is clear and conspicuous, then consumer welfare is maximized by enforcing it.²²

The five propositions enumerated in this part of the paper, propositions that most economists who have studied the safety-liability area would probably consider persuasive,

Footnote 21 continued

Now suppose that we increase the losses from the accident by multiplying L by some positive number, n . Our loss function becomes $nL(y)$ instead of $L(y)$. But differentiating as before with respect to the loss function yields as our formula for the injurer's optimal expenditure on care

$$nB_y = np_y D,$$

which of course is identical to the formula for $L(y)$ since we can divide both sides of the equation by n . This is true even though the probability of an accident is greater when the loss function is $nL(y)$ rather than $L(y)$. The probability of having at least one accident in n occurrences (where n in the products liability context might for example be the number of automobiles of some type) is $1-(1-p)^n$, so that if p were 001 (one in a thousand) and n were 2000, an injury would be almost certain (the probability would be about .86). Yet there would be no reason to treat this case differently from a case in which n is one, so far as sanctions for failure to avoid the accident are concerned; the optimal care for the potential injurer to take is identical in the two cases.

22. See, e.g., Posner, supra note 3, at 137. But there is some disagreement on this point. See Ordovery, supra note 3, who argues that disclaimers enable low-risk consumers to opt out of the risk pool consisting of the manufacturer's consumers and thereby impose a cost, in higher prices, on those high-risk consumers whom the manufacturer continues to insure. This doesn't seem a persuasive economic argument against disclaimers, however, as it would imply that insurance companies should be forbidden to compete by offering better terms to low-risk insureds. No one believes this.

would probably also have been accepted by most courts until the late 1960s. Since that time, there has been a revolution in state products liability law brought about by state court judges. As a result, each one of these propositions is now regularly rejected in products liability decisions. The result is a body of law that misallocates resources. Although many economists might favor a thorough-going reform of state products liability law to bring it into harmony with our five propositions, the remainder of this paper discusses a single proposal to amend existing federal law on automobile safety, a proposal that if adopted might be a sensible first step in controlling the excesses of products liability law.

II.

As mentioned at the outset of this paper, the National Traffic and Motor Vehicle Act forbids states to enact safety standards in areas where there is a federal standard promulgated under the authority of the Act, but allows state judges and juries to reject the federal standards in determining liability in products cases. State regulation is preempted when it is done by the legislature but permitted when it is done by the judicial branch. The economist is able to see, perhaps even more clearly than the lawyer, that this pattern involves a contradiction. From an economic standpoint, the decisions in liability suits are regulatory. As noted in Part I, the economic analysis of tort law stresses the regulatory function of that law. Decisions in tort cases, operating

as precedents, induce changes in potential defendants' behavior via the threat of sanctions in the form of damage judgments if they refuse to conform their behavior to the standards established in the case law and injuries result. The regulatory effect of tort law is especially pronounced when punitive damages are awarded, as they frequently are in products cases. The punitive component of a damages award is functionally equivalent to a fine, and often it is a larger fine than would be imposed for violation of an explicit legislative standard of care. It makes no economic sense to view state legislation of safety standards as regulatory but state tort law decisions as nonregulatory. The decisions too are regulatory and if they are inconsistent with federal safety regulations the case for federal preemption is as strong as where the state promulgates safety regulations through its legislative organ. Thus, whatever reasons led Congress to give federal safety standards preemptive force against state legislation argue equally for giving them preemptive force against state common law judges and juries.

Even if state tort decisions had no regulatory effect (as we shall see in Part III, the unpredictable and inconsistent character of jury determinations of liability may often lead motor vehicle manufacturers to throw up their hands and not try to make design changes that might convince a jury their product was not defective), there would be a strong argument for federal preemption based on elementary concepts of cost-benefit analysis. There is at this time, to my knowledge,

no politically realistic proposal pending to abolish NHTSA or prevent it from issuing safety standards. Therefore, the incremental social costs of using those standards to control liability in state products liability lawsuits are zero.

Compare the costs of using state judges and juries, lawyers, and expert witnesses to fashion standards of product safety. All that expense at the state level is wasted from a social standpoint unless the state tort system can do a better job of promulgating vehicle safety standards than NHTSA even in those areas where there is an applicable federal safety standard. The analysis in Part I of this paper indicates that it is most unlikely that the design choices being made by state judges and juries in areas covered by federal safety standards are better than the choices embodied in the standards. If so, there is no economic benefit in allowing the states to continue to regulate these choices through their tort systems; there are, however, substantial costs.

Finally, as also shown in Part I, the Coase theorem implies that the law should not seek to alter the customary standard of care designed for the protection of the consumers of a manufacturer's product. The market will bring about an optimal standard, and the proper role of the courts in products liability cases is to police adherence to that standard so that manufacturers will not undershoot it without compensating their consumers for the heightened risk of injury. This means that the whole program of federal promulgation of safety standards is probably misconceived, at

least from an economic standpoint. (We are speaking, as throughout this paper, only of standards designed to protect the occupant of the vehicle, as distinct from standards designed to protect other drivers, pedestrians, bystanders, and others who are not in an actual or realistically potential contractual relationship with the vehicle manufacturer.) If the federal safety standards are already too high, trying to create still higher standards through state tort law will reduce consumer welfare still further.

III.

The arguments in Part II assume that there is no special virtue in maintaining a particular allocation of responsibilities between the state and federal government. In fact, however, there is an economic theory of the federal system.²³

23. See, e.g., Jerome Rothenberg, *Local Decentralization and the Theory of Optimal Government*, in *The Analysis of Public Output* 31 (Julius Margolis ed. 1970); George J. Stigler, *The Tenable Range of Functions of Local Government*, in *Staff of Joint Econ. Comm., Federal Expenditure Policy for Economic Growth* 213 (1967); Charles E. McClure, Jr., *The Interstate Exporting of State and Local Taxes: Estimates for 1962*, 20 *National Tax J.* 49 (1962); Mancur Olson, Jr., *The Principle of "Fiscal Equivalence": The Division of Responsibilities Among Different Levels of Government*, 59 *Am. Econ. Rev.* 479 (1969); Sam Peltzman and Nicolaus Tideman, *Local versus National Pollution Control: Note*, 62 *Am Econ. Rev.* 959 (1972); Susan Rose-Ackerman, *Does Federalism Matter? Political Choice in a Federal Republic*, 89 *J. Pol. Econ.* 152 (1981); Jerome Stein, *The 1971 Report of the President's Council of Economic Advisers: Micro-Economic Aspects of Public Policy*, 67 *Am. Econ. Rev.* 531 (1971); Gordon Tullock, *Federalism: Problems of Scale*, 6 *Public Choice* 19 (Spring 1969).

So far as relevant here, this theory contains two principal strands. One is a general, but not universal or uncritical, preference of state over federal, and local over state, regulation--where feasible. The reason is competition.²⁴ If local regulation is inefficient, people can escape from it fairly easily by moving to another locality. If state regulation is inefficient, people can escape from it, at slightly higher costs, by moving to another state. But if federal regulation is inefficient, people can escape from it only by moving to another country and the costs of such relocation are likely to be very high. To be sure, even at the national level, oppressive regulation may result in a population outflow, a "brain drain" for example, sufficiently costly to the authorities to induce a modification of the regulation. But it is clear that the lower the level at which regulation is imposed, the more of a competitive check on abuses of regulation is imposed by the ability of people to vote against it with their feet, which is often a more effective method of influencing public policy than through the political process.

But the qualification that regulation should be imposed at the lowest feasible level is a vital one. The second principal strand of the economic theory of the federal system recognizes the problem of externalities across, not within,

24. As stressed in, for example, Richard A. Posner, *Economic Analysis of Law* 521-22 (2d ed. 1977); Stigler, supra note 2.

jurisdictions. The lower the level of regulation, the greater the danger that the regulatory authority will impose costs on people to whom it is not answerable politically.²⁵ The competitive check on abuses of regulation is greater, but the political check weaker, the lower the level at which regulation is imposed. To illustrate, suppose states were free to impose tariffs. The tariffs would impose costs on residents of the states imposing them, but they would also impose costs on residents of other states, who cannot influence the political process in states in which they do not vote.

In short, the danger of national legislation is monopoly and the danger of state or local regulation is political irresponsibility. Both dangers are serious and therefore an uncritical determination to turn all regulation over to the states would lack convincing support in economic theory.

The danger of political irresponsibility is illustrated by the situation today in regard to products liability law affecting the design of motor vehicles. Because most alleged design defects in motor vehicles cannot be corrected by "add-ons" (comparable to emission controls), and because there are substantial economies of scale in the manufacture of such vehicles, a state whose judges and juries use the

25. This point is stressed in an extensive literature. See, e.g., McClure, supra note 24; Posner, supra note 2, at ch. 26; Rose-Ackerman, supra note 24; Jack L. Walker, The Diffusion of Innovations among the American States, 63 Am. Pol. Sci. Rev. 880 (1969); Olson, supra note 24.

threat of heavy compensatory and punitive damages to in effect mandate a design change in an automobile or other motor vehicle imposes costs on residents of all the other states--and costs that are unwanted by those residents, if they don't value the particular design change as much as the state imposing it. An economist would think it obviously inefficient to allow the state legislature of California to specify the design of cars sold in Delaware. But that is just what happens in effect when California, acting through its court system, imposes such heavy tort penalties on manufacturers who do not make certain design choices that they coerce those manufacturers to redesign their cars. Economy-of-scale considerations will induce a manufacturer to redesign his cars wherever sold rather than build a specially designed car for sale in California. As a result, the residents of Delaware will pay more for cars in order to satisfy the preferences of the California judiciary. This is analogous to the imposition of a tariff by California on some good that is bought by Californians from producers located in Delaware. It differs fundamentally from a market solution, where the preferences of California and Delaware residents would be weighted by their willingness to pay -- not by the tort penalties their courts happens to impose.

The analysis is not affected in its essentials if manufacturers do not try to make design changes that will satisfy juries in California or other states that favor products liability plaintiffs. This is probably the pattern

in many, and perhaps most, cases, since juries in different states, and even those within a given state, may make inconsistent decisions. Design changes often involve trade-offs between reducing the injury consequences of one kind of accident and increasing the injury consequences of another kind. This is clear in the case of rigid windshields and collapsible bumpers and even seat belts, which reduce vehicle occupants' potential injury in some accidents but increase it in others (e.g., where the occupant is trying to escape from a burning car). Juries can and do find the same manufacturer liable both for adopting a safety device and for failing to adopt it. In light of the possibility of inconsistent decisions, instead of modifying the design of their products manufacturers may simply accept heavy products liability costs as an unavoidable cost of doing business.

Because the manufacturers cannot feasibly charge higher prices in states that favor products liability plaintiffs than in other states, the added cost of doing business in those states is reflected in a general price increase to all of the manufacturers' consumers, wherever located. This means that the Delaware resident pays more because of the political choices being made in California, but he gets nothing for his money -- instead, he subsidizes purchases by California residents. Indeed, so viewed, contemporary products liability law is bringing about random, nonprogressive, politically irresponsible transfers of wealth among automobile consumers.

Furthermore, contemporary products liability law is resulting in too many purchases of automobiles in states such as California and too few in states such as Delaware: the taxing of Delaware residents to pay for California products liability awards results in Delaware prices that are above long-run marginal cost and California prices that are below this level. In addition, depending on the elasticity of demand for autos in California relative to the rest of the country, products liability law may be resulting in production of too few cars. If so, auto workers and shareholders are bearing part of the burden of financing tort awards made in pro-plaintiff states.

These transfers and inefficiencies are not what is contemplated when people say that the balance between state and federal regulation inclines too much to federal regulation. By limiting state standard setting that affects consumers, workers, and shareholders in other states, the proposed amendment to the National Traffic and Motor Vehicle Safety Act will bring us closer to the proper balance.

An additional consideration relates to the international competitive position of the American automobile manufacturers. Assume the principal effect of modern products liability law applied to automobiles is not to bring about additional design changes but simply to raise the marginal cost of automobile production. In other words, assume that products liability cases are operating as a tax on the automobile manufacturer (and hence on his customers and suppliers, to

whom the bulk of the higher cost is probably passed on). It is a tax on any manufacturer selling in the U.S., whether foreign or domestic, but it is not thereby an equal tax. It discriminates against American manufacturers in this important sense: a larger fraction of the output of the American manufacturers is sold in America than the output of foreign manufacturers is sold here. Suppose a U.S. manufacturer sells 50 percent of its output in the U.S. while a Japanese manufacturer sells 10 percent of its output in the U.S. Then the tax represented by U.S. products liability law is imposed on 50 percent of the U.S. company's business but on only 10 percent of the Japanese company's business. If the U.S. and Japanese manufacturers cannot separate their markets (that is, charge higher prices in the U.S. than abroad to reflect the differences in expected liability costs), then the unequal incidence of the tax will raise the price of U.S. cars relative to Japanese cars and cause consumers to substitute away from American cars toward Japanese cars. This would not matter if Japan and other foreign countries had products liability laws like those of our states, with juries, punitive damages, etc. They do not. No foreign country to our knowledge uses a jury in civil cases; most do not award punitive damages in any cases; none compute compensatory damages as generously as we; none has a set of substantive rules of products liability as favorable to plaintiffs as we. Hence the tax is much greater on U.S. manufacturers than on their foreign competitors.

A final point remains to be made: the federalism issue raised by the proposed amendment to federal motor vehicle safety legislation and discussed at such length in this part of the paper is probably a red herring. A genuine federalism issue is raised whenever it is proposed to shift a regulatory responsibility from state to federal government. But that is not the proposal. Federal regulation of motor vehicle safety is, for now at least, an established part of the regulatory landscape. If it were proposed to substitute state for federal regulation of motor vehicle safety, this would present interesting questions; but no such proposal is on the table at the moment. Taking federal regulation of motor vehicle safety as a given, it is clear that the proposed amendment would not shift regulatory responsibility from the states to the federal government. Rather, it would reduce the overall regulatory burden on the motor vehicle industry by limiting state judicial regulation that at present overlaps with regulation by NHTSA.