I. The Basic Notion of Compensation

In the common law, the basic goal of most damage payments (the kind we call compensatory damages) is to "make the victim whole." What does that mean? It is usually interpreted to mean, "make the victim as well off as she would have been if the accident had not taken place." In other words, the object is to compensate the victim for her loss.

In economic terms, what does it mean to compensate someone? We can think of compensation in terms of indifference curves. An indifference curve is a curve that connects all points that are of equal value to a person. The downward slope of an indifference curve represents the fact that people are usually willing to trade off one good thing for another, so long as they get enough of the other. [Draw a standard indifference curve, with two goods; for example, DVDs and CDs. Show how trade-offs can be made along the curve.] In the law, it is often the case that the damage done to someone is medical in nature. It might be the case that money can repair some of the medical damage (by paying for medical services), but often there is irreparable damage. In this case, compensation cannot restore the victim to her previous position, but it can restore her to her previous level of utility. [Change the goods on the axes to health and wealth, and show how greater wealth could compensate for lower health.]

Does the common law notion of compensation fit well with the economic notion? In general, it does, but there are some differences. While in principle the law embraces the idea of "making the victim whole," in practice the law does not always do so. In many cases, the damages awarded are based on pecuniary losses (medical bills and lost wages), rather than a judgment about how much money is truly necessary to make the victim as well off as before. Pain and suffering damages partially fill the gap, but not always or entirely.

Also, recall that the notion of Kaldor-Hicks efficiency was based on the idea of potential compensation. For a change to constitute an improvement, it had to be that the "winners" improved their situation enough that they could, in principle, compensate the losers so they're just as well off as they would have been absent the change. But there is an important difference here. The common law's compensation principle requires actual compensation of the losers, whereas K-H efficiency requires only potential compensation. Does this mean that the common law is actually aiming at something like Pareto efficiency?

Not necessarily. The law only requires compensation in some cases -- specifically, in those cases where a liability rule (rather than a property rule) is used. The real issue is one of providing incentives. Consider a rule of liability that requires polluters to compensate those who suffer from pollution. From an (Kaldor-Hicks) efficiency standpoint, we want the pollution to occur if and only if the benefits from the pollution
are greater than the costs it imposes. What better way to make sure that's the case than to
tell the polluter to put his money where his mouth is? If the benefits of his polluting
activity are great enough, he should be able to pay the damages and still be better off. If
he can't, then the polluting activity must not be worth it after all. Thus, the requirement is
compensation is used to make sure that people bear the full costs of their activities.

Of course, we've seen some possible problems with this approach. The Coase Theorem
informs us that, if transaction costs are sufficiently low, explicit damage payments may
not be necessary. We could adopt a property rule instead of a liability rule, and the
polluter would still consider the damage done by his activity as a forgone payment -- a
kind of opportunity cost. And in many cases, that's just what we do: trespass, car theft,
and many other activities are punished with property rules instead of liability rules. In
addition, we know that even under a liability rule, the plaintiff will still end up worse off
(not “made whole”) because the court-set damage payment may be too low. Seen from
this perspective, the role of the compensation principle is not to enforce the Pareto
criterion, but to enforce the Kaldor-Hicks criterion by ensuring that, in cases where
holdout problems or public good problems could deter private transactions from reaching
efficient outcomes, there is another legal means of making those transactions occur.

II. Compensation for Loss of Life (in Economics)

One potential problem with the compensation principle is that it's hard to apply when the
damage caused by an action is the loss of life. Many would argue that a human life has
infinite value, at least to the person whose life it is. Would you agree, for any amount of
money, to let someone kill you (assuming, of course, that you're not terminally ill)?

This is certainly a problem, but not as great of a problem as it might seem. It's easy
enough to show that people can't possibly place an infinite value on their lives. Why?
Because people regularly take risks that create a positive probability of their own death,
such as driving cars. The probability may be small, but anything multiplied by infinity is
infinity. Anything you can do to reduce that probability should have infinite value. You
should constantly be shifting resources into activities that prolong your expected lifespan
in any way. If you're not like that, then you have to admit that additional years on your
life don't have infinite value.

Let's put it another way. Most of the time, the activities we're concerned with are ones
that lead to a probability of death, not a certainty. But a probability of death for
individuals translates into a certainty of death for some (unidentified) fraction of the
population. Would it be possible to reduce the fraction of individuals killed to zero? No,
and in trying to do so, we'll run into the law of increasing opportunity cost. The more
lives we save, the less of other desirable things will remain for the living. Suppose you
had the chance to decide for society how the trade-off between lives and other values
would be made, without knowing in advance which person in this society you were going
to be. (John Rawls would call this a veil of ignorance.) Would you choose to have the
absolute minimum number of lives lost? I wouldn't.
From an economic perspective, then, the question is one of deciding the efficient level of risky activities that could lead to loss of life. As discussed in a previous lecture, there are two types of punishment that we could employ to deter individuals from imposing too much risk on others: ex ante and ex post. An ex ante punishment would place a fine on the risky activity. An ex post punishment can accomplish the same goal by placing a much larger fine on the bad outcomes that result probabilistically from the same activity. So: if you buy the idea that an ex ante punishment could induce the optimal level of risk-taking, then let us define the "value of a life" as the amount of money which, if imposed as an ex post punishment, would be just enough to induce the same amount of risk-taking.

Let's say that an activity increases your chance of death by 1/10 of one percent. How much money would someone have to pay you to accept the risk? Give me a number -- let's say $1000. So the person who wants to do this activity would, in an ex ante punishment scheme, have to pay you $1000. What amount of money would give him the same incentive from an ex post perspective?

$$A \times 0.001 = $1000$$
$$A = $1,000,000$$

So an ex post payment of one million dollars (to your estate) should place the correct incentives on this activity. For simplicity, we call A “the value of life,” but notice that A could differ depending on the risk we’re talking about. We’re not saying that anyone would accept a million dollar payment in exchange for losing their life -- only that they’d accept a $1000 payment in exchange for a one-in-a-thousand chance of losing their life.

III. Compensiation for Loss of Life (in the Law)

Oddly, the old common law did not award damages for loss of life. The justification was that your claim to compensation died with you. From an economic standpoint, this makes no sense, because the issue is not compensation for the victim but incentives for the injurer. The common law began to change in a more economically sensible direction in the 19th century, and now your heirs can sue for damages to be paid to them. These damages include your lost wages (minus what you would have spent on yourself), and sometimes compensation for lost companionship, pain and suffering of family members, etc. But the justification is still in terms of damage done to your survivors, rather than an amount sufficient to compensate you for the loss of your life.

DDF proposes that the legal system should, instead, use a calculus like the one I performed above to find the value of your life to you (meaning the amount it would have taken to induce efficient behavior). However, he notes that there is still a problem here. If the claim can only be made by one's survivors, what about the person who has no family? How can we make sure that people who create risks do so with proper regard for the lives of people without family?

DDF proposes an innovative solution: a market for inchoate tort claims. An inchoate claim is one that has not been "born" yet, because no accident has taken place. Under the status quo, only you or (in the event of your death) your family can own the right to
demand tort damages. In DDF's system, you could sell your right to damages to someone else. Who might buy such a claim? Well, firms like insurance companies might. Say there's a 1/10 of a percent chance that you will die in an accident, and the courts will award $1,000,000 to a successful claimant. In expected value, the right to make this claim is $1000, minus some administrative and legal costs. So an insurance company could buy a "tort future" from you, paying you $900 for the right to make a legal claim in the event of your death. This system would give risk-creators the appropriate incentives, while making sure the (expected value of the) compensation goes to you in your lifetime.

You might wonder why we don't instead just use ex ante punishments. Just charge people a fine for their activity equal to its expected cost, and then give the payments to the people who could get injured. But as we know, there are advantages to ex post punishment, chief among which is that it makes people use their private information. We cannot know in advance for every person what types of precautions they could be taking. The advantage of DDF's proposed system is that it effectively has the same result as an ex ante system in terms of compensating potential victims (you get $900 from an insurance company), while the risk creator still faces the full expected cost from expected ex post damage claims.

One problem with this system is that people could naïvely underestimate the probability of an accident happening to them. They might accept the money now, spend it, and then leave nothing for their families in the event of their deaths. But in that case, why do people buy life insurance? Does it make sense for the legal system to act as a provider of life insurance policies, when the insurance industry does so much more efficiently?

**IV. Compensation for Other Injuries**

The system that DDF proposes for loss of life was inspired by the fact that dead people don't benefit from compensation payments. But there's no reason we can't use DDF's proposal for other types of injuries.

If some type of activity creates a risk of, say, blindness, anyone who is actually blinded can go to court and demand compensation. Now, for the compensation payment to serve its economic function -- inducing efficient behavior by the injurer -- then the compensation must be not merely enough money to cover your pecuniary loss (doctor visits, lost wages, etc.), but in fact enough money to make you just as happy as you would have been with your sight.

This provides the correct incentive to the injurer, but it doesn't necessarily make sense for the injured party. One of the problems with blindness (and other injuries) is that money is simply less valuable to you after the injury. If you knew that you stood a certain chance of going blind and not being compensated, how much insurance would you buy against that possibility? Would you buy a policy that would pay out an amount equal to what a court would have to award you after the fact to compensate you? Probably not. You recognize that the premium for such a policy would be too high -- your money is
more valuable to you now, in your uninjured state. You'd buy some insurance, but not that much.

So here's the problem. Compensation payments serve two purposes: to deter inefficient behavior by injurers, and to provide a form of insurance for victims. The problem is that the optimal amount for deterrence may be much greater than the optimal payout for an insurance policy.

DDF's "tort futures" idea provides a potential solution to this problem. You currently have an inchoate tort claim against people who might make you blind. You recognize that some of the money you'll be paid in the event of blindness would actually be more useful to you now, with your sight intact. So you sell an interest in your future tort claim to an insurance company. (Unlike in the case of death, you don't sell the whole claim, because you want to have some of the compensation award in the event that you go blind. But you don't want to have the whole compensation award.) They pay you some money, in exchange for the right to claim a portion of your damage award if you are blinded.

[An aside: One more modification is needed to make the system work just right, though. Compare these situations: (a) In the event of your blindness, you'll get enough money to make you as well off then as you are now. This is a huge amount of money. (b) Same as (a), but now you are enabled to transfer some of the money from your blind state to your non-blind state, thereby making yourself better off. Now, if (b) is better than (a) for the victim, then we have to recognize that the compensation being paid by the court is actually too large when the victim has the right to transfer money from one state to another. It is larger than the true cost to you of the risky activity, and would thus over-deter. Therefore, the compensation payment in (b) should actually be a bit smaller than the payment in (a) in order for it to deter optimally. But both schemes would involve larger compensation payments than in the status quo, where often only pecuniary losses are awarded.]

Again, the problem with this system is that naïve people may sell their inchoate tort claims while underestimating the likelihood of getting harmed. As a result, they might sell the claim, spend the money now, and then be lacking in money when the accident occurs and they really need it. They could, of course, sell only part of the tort claim (as indicated above), or sell the whole claim and use part of the proceeds to buy a regular insurance policy. But if people are too stupid or myopic to do that, then it could make sense for the legal system to act as an insurer of sorts by limiting the sale of inchoate tort claims.

Another potential problem with the sale of inchoate tort claims is that the victim, who no longer has an interest in the outcome of the trial if he won't get the profits from it, may have an incentive problem. The victim of an accident is often the most important witness in the trial, but why bother being a witness if you don't benefit from doing so? To get around this problem, the inchoate tort contracts would need clauses requiring testimony.