Chapter 3 examined situations where transactions costs were sufficiently low to render legal rules irrelevant from an efficiency point of view. If these conditions always prevailed and transactions costs were sufficiently low – and if economists cared only about economic efficiency – then the study of law and economics would not be very interesting (and this would be a very short book!). In such a world, parties would always be able to bargain around the law, and as a result of the reasoning embodied in the Coase Theorem, legal rules would simply not matter for efficiency – although they would of course matter for distribution and for the parties involved.

It would be a grave mistake, however, to conclude from our analysis of the Coase Theorem that ‘legal rules do not matter’, or that ‘property rights do not matter’. The reason for this is straightforward: legal rules, property rights and the institutions that support markets matter precisely because transaction costs are usually not zero. This chapter and those which follow illustrate the importance of legal rules for efficiency by examining cases where transaction costs are so high as to rule out all forms of bargaining.

In this chapter we examine the opposite extreme case: we analyse situations where transactions costs are high and bargaining between parties is prohibitively costly, so that no negotiation is possible. In other words, we rule out situations covered by the Coase Theorem.

The kinds of situations examined in this chapter are typically governed by accident law or tort law. These legal rules aim at drawing a line between those harmful events that should lead to compensation, and others for which the harm should ‘lie where it falls’. Throughout the
chapter we will distinguish between two parties: the *injurer* and the *victim*. This terminology needs to be used with a great deal of care. As the analysis in Chapter 3 showed, *social costs really are social*. To take the Chapter 3 example, if the residents enjoy a property right and enforce that right without bargaining with the factory, then in a very real sense the residents could be said to be harming the factory, by preventing the factory from producing. This conceptual approach contrasts with the Pigouvian tradition, which views the factory as an injurer whose harmful actions must somehow be constrained and controlled. The Coasean approach strips away this presumption and emphasises the reciprocal nature of harm. This is one of the key insights of Coase's analysis.

This chapter presents a canonical model of accident law, which serves as a baseline model for many of the other topics discussed in this book. There are two important considerations to keep in mind throughout this chapter:

- We will study *accidental* harm, which is essentially *unpredictable*; and
- The chance that harm actually occurs and the damage that is inflicted depends on how much *care* or *precaution* is actually taken.

In other words, the probability of harm occurring depends on the level of care taken by the injurer, and care is costly. This situation is best summarised by the concept of *probabilistic externalities*. An externality is probabilistic if the link between the original action and its effects on bystanders is uncertain, as opposed to an action whose effects are more or less completely foreseeable and deliberate.

The key economic issue explored in this chapter is as follows: when party A undertakes an activity that imposes an (uncertain) and otherwise uncompensated cost on another party B, should A compensate B, or should the damage ‘lie where it falls’? Further, if A should compensate B, how much compensation should be paid?

In contrast to most textbook treatments of the issues, the analysis in this chapter also focuses on the economics of accident law in market settings. The point of departure in section 4.2 is the basic unilateral care model, where only one party can take steps to reduce the probability of accidental harm occurring. This model is first examined within a non-market setting. Section 4.3 extends the analysis by applying standard accident laws to a competitive market setting. Section 4.4 studies the special but very relevant case of the unilateral care model in a market setting where injurers are firms in a competitive market, but where victims of harm are themselves also firms in a different perfectly competitive market. Monopoly and oligopoly