

**CONSUMER PROTECTION LEGISLATION:
AN EXERCISE IN PROPERTY
RIGHTS ECONOMICS**

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INFORMATION IN THE MARKET

The main characteristic of the used car market is that one side of the market is more informed than the other about the properties of the goods traded. This asymmetrical information implies that the market price does not communicate to the potential buyer all the useful information to appreciate the quality of the product. This means that the consumer has to invest in more information to overcome this situation. It will be argued below that the market offers to the potential consumer a portfolio of arrangements that help him to minimize the transaction costs of buying a good used car. The next section explains how the market responds to differential information by analyzing the behavior of three typical consumers. It will be shown that the market provides a partial reduction in the informational asymmetry and that there are no further benefits to be gained by the less-informed agents from acquiring more information. The second section describes how the Quebec Civil Code and its interpretation by the courts of justice guarantees that a wide variety of selection processes are available in a market with positive transaction costs. The next section deals with the manner in which consumer protection legislation reassigns liability for used cars and its allocative and distributive consequences. In the final section, we attempt to show that such wealth transfers can be rationally legislated by vote-maximizing politicians.

Information Costs and Risk Level

If a consumer¹ thinks or believes that not only the search and information costs, but also the bargaining and decision costs of buying a good used car are too high relatively to his other market opportunities, he can deal directly with more reliable automobile dealers who offer appropriate warranties. This means that such a consumer is risk averter and does not have any comparative advantage in acquiring information on quality. He does not find it to his advantage to do his search and bear the risks of defect because of the high costs associated with this selection process. It proves more advantageous for him to buy guarantees, warranties or insurances in the market rather than "produce" his desired level of information and risk-bearing. Although ill-

1. This part has been inspired by the works of Oi. See W.Y. Oi, "The Economics of Product Safety", (1973) *Bell Journal of Economics and Management Science* 4, no 1, Spring, 3-28 and "The Economics of Product Safety: A Rejoinder", (1974) *Bell Journal of Economics and Management Science* 5, no 2, Autumn, 689-695.

informed or less informed, he does obtain his desired level of quality by this means. As a matter of fact, auto dealers realizing that their long-term interests lie in maintaining standards and not in adopting short-sighted strategies do offer guarantees and insurances². In this specific context, the full price he has to pay includes the market price plus the information costs and the cost of the guarantee.

A consumer can also engage more directly in the production of the desired goods by sharing with the market the information costs and the level of risks. In this second case, the consumer combines his own time and market goods to produce a commodity. More precisely, the consumer uses his technical knowledge and his entrepreneurial capacity to organize market resources originating from some specialized institutions, for example Esso clinics and the Automobile Club. The social function of those institutions consists, as intermediaries, in accumulating and communicating information, in intervening between transacting parties and thereby in reducing information costs by adapting the relevant information to the parties' needs. In the first possibility previously analyzed, the consumer minimized his direct participation to the production of the commodity, a good used car, by dealing directly with the market. He felt he could not be superior to the market. This second possibility permits a more advanced vertical integration of the consumer's activities. The selection of a used car depends partially on his technical ability but also on purchased market resources. Such a commodity production function is chosen by a consumer who possesses decent technical abilities and positive attitudes toward risk-bearing. Having internalized what his entrepreneurial capacity permits, he shares the remainder with the market to compensate for his technical deficiencies and his relatively limited preference toward risk. The full price of a used car, for him, can thus be expressed as the sum of the market price, plus the price of the market goods, plus the time used to find a good used car, plus the expected cost of a defect.

A third commodity production function is also available to the consumer who is a risk lover and is capable of assessing the quality of the goods because of his high level of technical abilities. In this case, the consumer assumes all the information costs and the expected cost of defect because he believes he is more able than the market to minimize

2. "Inaccurate information does not necessarily imply poor market results, as is generally claimed". This conclusion is from L. COURVILLE and W.H. HAUSMAN, "Warranty Scope and Reliability Under Imperfect Information and Alternative Market Structures", (1979) *The Journal of Business* 52, no 3, July, 361-378.

actual and potential transaction costs. As an entrepreneur, he chooses the process which permits the production of the commodity at a minimal cost to him. He does his own search and bears the entire risk. Such a consumer incurs lower costs in the event of a defective car and for that reason is willing to incur higher expected defect costs in order to obtain a lower market price for non defective cars. Consequently he may test the used car himself or hire a mechanic to do so; he may trade with friends or he may use the technical data contained in specialized magazines such as *Car and Driver*, *Consumer Report* and so on. Full price to him includes the market price, plus information costs, plus the risk of the used car being defective.

The market mechanism thus offers a wide variety of arrangements to minimize the problem of imperfect information and the sharing of risks. The consumer is able to express his free choice in choosing a commodity production function which is consistent with his own cost-benefit analysis. Such consumer invests the amount of money and time that minimizes his information costs and that reduces his level of risks to an acceptable level as perceived by him. The full price of the used car varies inversely with the technical abilities of the consumer and his attitudes toward risk. The difference between two full prices reflects the "implicit price" of producing or internalizing the information costs and the risks.

This analysis of the market mechanism does not in any way rule out the possibility that used car sellers engage in fraudulent practices in the strict sense of Darby and Karni³. For reputable traders, the client relationship is part of their organizational capital, so that attempts to deceive and cheat by them will tend to be low. On the other hand the incentives to fraud are higher for those sellers who earn their living exclusively on the market for used cars. The actual level of fraud is determined not only by the costs of obtaining additional information to assess the quality of the commodity, but also by the manner that the legal system interprets breach of contract related to fraudulent intent and misrepresentation.

The Quebec Civil Code and its Interpretation by the Courts

Information is costly not only to produce but also to absorb; for that reason, optimal information is not infinite. It has been seen that the market system affords the consumer various means for alleviating the lack of information. We will now see how a legal system, which

3. M.R. DARBY and E. KARNI, "Free Competition and the Optimal Amount of Fraud", (1973) *Journal of Law and Economics* 16, no 1, April, 67-88.

regulated the sale of used cars prior to the enactment of the legislation on consumer protection⁴, tended to favor the production of a non-negligible quantity of information by apportioning costs between sellers and consumers on the basis of which party could produce it at minimum cost.

The Civil Code first lays down that it is the consumer's duty to obtain all necessary and useful information in order to avoid the risk of making an unsatisfactory deal. As a matter of fact, according to article 1523 of the Civil Code, in the absence of any conventional warranty, the seller is not bound for apparent defects which the buyer might have known of himself. However, the seller is obliged to warrant the buyer against latent defects in the thing sold (1522 C.C.).

The parties may nevertheless, by special agreement, add to the obligations of the legal warranty, or diminish its effects, or exclude it altogether (1507 C.C.). The consumer may be relieved from his obligation to examine the thing and to take the necessary precautions provided he obtains from the seller conventional warranties rendering the latter responsible for apparent defects as well⁵. We have shown above that the prudent consumer tends to negotiate such additional warranties with his seller. Likewise, the seller may be free of legal responsibility for latent defects in the thing sold if he stipulates that he shall not be obliged to any warranty (1524 C.C.). The consumer having positive attitudes toward risk will presumably negotiate on a non-warranty basis. In either case, it is reasonable to expect that the price will vary accordingly. Thus, the Civil Code defines the initial rights and obligations of the parties while permitting them to rearrange such rights and obligations according to their respective interests.

As to the legal warranty against latent defects, the difficulty of determining with certainty the dividing line between apparent and latent defects and of setting down standards of assessment gave rise to numerous studies, both doctrinal and jurisprudential⁶, as to the nature

4. The new Consumer Protection Act does not repeal the Civil Code provisions on sale. Because of its general purport, The Civil Code does not permit inclusion of specific legislations intended especially for consumer protection. The new Act is therefore a parallel legislation regulating the contracts as well as the business practices relating to a particular type of buyer, the consumer.

5. *Porter v. Bouchard*, (1918) 55 S.C. 412: "With such conventional warranties, the buyers were not bound to comply to the rules of prudence, examination of the thing, verification of the quantity or quality. The maxim of *caveat emptor* cannot be applied in their case".

6. J.W. DURNFORD, "What is An apparent Defect in the Contract of Sale?", (1964) *McGill Law Journal* 10, 60; J.J. GROW, "Comment on the War-

of the examination to be made by the consumer, and therefore as to the extent of his obligation to produce information. For instance, does the buyer have to apply for the services of an expert, or can he himself make a cursory examination of the product that he is buying?

A careful study of the jurisprudence on the sale of used cars tends to show, as suggested by David Cayne⁷, that the law courts rely on the "reasonable expectations of the parties" at the time of the contract, to maintain or dismiss the action of an unsatisfied consumer. In their analysis of the facts, the courts have time and again defined what a consumer may reasonably expect within the context of a particular transaction. In our opinion, the criterion of "reasonable expectations of the parties" fully renders the actual significance of the seller's legal warranty against latent defects. Indeed, article 1522 of the Civil Code stipulates that the latent defects must be such as to render the thing unfit for the use for which it is intended, or so diminish its use that the buyer would not have bought it or would not have given so large a price, had he known them.

The purchase of a used car involves a risk of which the consumer must be fully aware. Since there is not necessarily adequation between the price and the quality of a product, the consumer has to see to it that the existing variance is reduced to an acceptable level. These considerations are expressed as follows by Justice Ralston in the case of *Churchill v. Parker* (1953):⁸

"The purchaser of a second hand Hillman automobile which has travelled 19,600 miles cannot expect to receive a virtually new automobile and must expect some mechanical difficulties in the future and furthermore he is very imprudent if he does not have such automobile inspected prior to his purchase by a competent garage mechanic".

Although this statement suggests that the buyer must have the automobile examined by an expert, should he later on have to prove his right against the seller, a study of the facts of the case leads to the conclusion that the consumer's difficulties were rather of a kind that could reasonably be expected. A decision to the same effect was

ranty in Sale against Latent Defects", (1964) *McGill Law Journal*, 10, 341; Pierre W. MORIN, "Annulation de vente d'automobiles pour cause de vices cachés", (1975) *Revue du Barreau* 35, no 2, 209; Gilles THIBAUT, "Contribution à l'élaboration d'une approche *in concreto* dans l'évaluation qualitative des vices en matière de vente" (1971) *Revue juridique Thémis* 9, no 1, 61.

7. David CAYNE, "The Buyer's Remedy in Damages for Latent Defects in the Province of Quebec", (1976) *The Canadian Bar Review* 64, 106.

8. *Churchill v. Parker*, (1953) R.L. 509.

rendered in the case of *Fiset v. Baie St. Paul Automobile Inc.* (1977)⁹, where Justice Roland Angers dismissed the action in pointing out that the difficulties were “breakdowns bound to occur at any time in the case of a used car” and that “it is a well-known fact that the purchase of a used car itself involves a certain risk”.

On the other hand, where the defects exceed in extent and seriousness those that the consumer of a used car, sold with the usual legal warranty, may be likely to expect and accept, the courts maintained the plaintiff's action. In *Bourget v. Martel*¹⁰, the Court specifies as follows the expectations of the buyer:

“The one who buys a used automobile is entitled to receive an automobile that functions normally, and not a vehicle necessitating the expense of several hundred dollars in order to render it fit for use”.

In the case of *Lebrun v. Tardif & Fils Inc.*¹¹, the judge maintained the action of the buyer who had himself examined the vehicle in question. The decision is to the same effect in *Lemire v. Pelchat* (1957)¹², where the buyer had had a used grader examined by a mechanic. In those two cases, it was decided that the defects were such that the buyer would not have given so large a price, had he known them.

In short, it is the consumer's duty to verify the condition and quality of the object of the contract, and it is in fulfilling such obligation that he is to discover the apparent defects¹³. Indeed, the consumer is the one who knows best what use he intends to make of a certain product. And if to some extent he is held responsible for incurred losses, he will have more reasons to acquire information and use it¹⁴.

Another legal principle is incorporated into the Civil Code. The parties are expected to act in good faith when entering into a contract. The consumer may therefore assume that the seller's representations as to the state or quality of the product are true¹⁵. Thus, the Courts have

9. *Fiset v. Baie St-Paul Automobile Inc.*, (1977) P.C. 259. To the same effect, *Bouthillette v. Bourgetel*, (1978) P.C. 445.

10. *Bourget v. Martel*, (1955) Q.B. 659.

11. *Lebrun v. Tardif et Fils Inc.*, (1976) P.C. 546.

12. *Lemire v. Pelchat*, (1957) S.C.R. 823.

13. D. JACOBY, “Chronique de jurisprudence”, (1971) *Revue du Barreau* 31, 340.

14. R. MCKEAN, “Products Liability: Implications of Some Changing Property Rights”, (1970) in E.G. FURUBOJN and S. PEJOVITCH, *The Economics of Property Rights*, Cambridge, Mass. Ballinger Publishing Company, p. 55.

15. Good faith is always presumed, 2202 C.C.; “... good faith is the essence of contracts. It must preside not only at their making but also at their execution.

no hesitation in maintaining the action of an unsatisfied buyer whenever evidence shows misrepresentation on the part of the seller. Such was the case in *Benoît v. Métivier* (1948)¹⁶, where the consumer proved that the seller had stated that the engine was in running order and had been repaired, whereas the engine was out of order and necessitated costly repairs. Likewise, in *Jardine v. Allen* (1952)¹⁷, it was held that the consumer who buys a used automobile on the strength of a newspaper ad containing the words "in good mechanical condition" has grounds to ask for the cancellation of the sale, should the vehicle not function without costly repairs.

Even when a contract contains a non-warranty clause, the courts are reluctant to admit its validity, when the defects in a product are considerable and the facts suggest fraud by the seller¹⁸. Refusal by the courts to confirm a contract when a party to it was misled by the seller's misrepresentation suggests that the courts were aware that too much fraud is not conducive to the best allocation of resources. As argued by R.A. Posner, "The cost of making, and unmaking, the misrepresentation represents a dead weight social loss, and to the extent that misrepresentation can be deterred and prevented at lower cost by creating private or public rights of action against fraud, such enforcement is economically justified"¹⁹. In addition to the cancellation of the sale or a

The validity of contracts depends on it. The principle of not new..." *Cosmo Underwear Co. Ltd. v. Valleyfield Milk Mills Ltd.*, (1962) S.R.C. 420, 423.

16. *Benoît v. Métivier*, (1948) S.C. 53.

17. *Jardine v. Allen*, (1952) S.C. 126.

18. *Bourget v. Martel*, *loc. cit. supra*, note 10, 659. To the same effect, *Longpré v. St-Jacques Automobile Ltée*, (1961) S.C. 265; *Lebrun v. Tardif et fils Inc.*, (1976) P.C. 546.

19. R.A. POSNER, *Economic Analysis of Law*, (2nd Edition), Toronto, Little, Brown and Company, 1977, p. 81. It is to be noted that, apart from latent defects, the buyer may always have the sale cancelled if he proves fraud by the seller (articles 991 and 993 C.C.). However, the liability for nondisclosure of actual information as to a product presents a problem that is much more difficult to solve. Posner writes that:

"Nondisclosure may also impose costs but so does compelling sellers to provide information. Information is costly not only to produce but also to absorb, sellers and consumers alike are harmed if the legal system requires the production of a more than optimal quantity of product information. Hence, the question of liability for nondisclosure should turn on which of the parties to the transaction seller or consumer, can produce the information at lower cost".

R.A. POSNER, *Economic Analysis of Law*, (2nd Edition), Toronto, Little, Brown and Company, 1977, p. 83.

reduction in the price, the consumer may be granted damages from the seller if it proves that the latter knew of the latent defects. In like manner, a seller will be held liable for damages in all cases where he is legally presumed to have known the defects (1527 C.C.). An abundant jurisprudence determines that a specialized trader is legally presumed to know the defects²⁰. A buyer makes only occasional transactions on the used car market, while the trader earns his living out of them. The latter gradually develops such an expertise and knowledge of the product that he is in a position to appraise each unit at a cost lower than would its purchaser. It is therefore reasonable to hold the seller responsible for damages incurred by the buyer as a result of latent defects, which should induce the seller to reveal more information to the buyer on the quality of the product.

Finally, the defect from which the seller protects the consumer must be existing at the time of purchase. To decide otherwise would not ensure an optimal allocation of resources. The consumer would then have no reason to exercise prudence in the use of his car. To hold him responsible for losses resulting from abusive use has the effect of keeping the transaction costs lower. He is in this manner led to be more careful in the use of his vehicle, to give particular attention to maintenance costs and to weight potential time lost against benefit. In other words the buyer is induced to reduce the risk of incurring losses for which he would get no compensation²¹.

Finally, the difficulty of proving the existence of defects at the time of purchase explains the provisions of article 1530 of the Civil Code, which states that the buyer's action be brought with reasonable diligence. In that way the seller is informed in good time of the alleged defect, so as to be in a position to verify its existence and origin, and to ensure a complete refund in case of voluntary or forced cancellation of the sale²².

The Market Mechanism Under the Civil Code Regime

Our survey of the Quebec Civil Code and its interpretation by the various courts of justice suggests that it is designed to assure the existence of a variety of selection processes through the market. The consumer is able to choose freely the production function which

20. *Longpré v. St-Jacques Automobile Ltée*, (1961) S.C. 265; *Joyal v. Vanasse*, (1967) R.L. 497.

21. R. MCKEAN, "Products Liability: Implications of Some Changing Property Rights", in E.G. FURUBOJN and S. PEJOVITCH, *op. cit. supra*, note 14, p. 56.

22. *Houle v. Paquette*, (1961) S.C. 197.

reflects his comparative advantage. Whether he resorts exclusively to the market by dealing only with reputable traders or deals partially with the market by means of information specialists or whether he chooses to "produce" the commodity himself, thus internalizing all the information costs and risks, the consumer receives a certain assurance that the legal system which underlies the operation of the economy, tends to minimize policing and enforcement costs.

As first discussed in the classic paper by Akerlof on the market for lemons, some markets can be found where buyers have to rely on statistical averages to estimate quality, as a result of their lower level of information relative to sellers. In such conditions, social returns can be greater than private returns when sellers offer higher than average quality products and it cannot be stated *a priori* that all externalities that are worth internalizing are actually internalized by the market for used cars. On the other hand, the optimal information and risk in a world with frictions is not perfect information nor zero risk²³. Where transaction costs exist, not all external economies of information are to be internalized nor are all risks to be insured. In a regime in which transaction costs are more than negligible, some inefficiency subsists at market equilibrium because the opportunity cost of resources invested in information is generally positive. So any proposal to reduce externalities of information by non-market mechanisms has to be compared with the performance of a market with positive transaction costs and not with an extreme situation where no external economies are internalized in equilibrium. It seems that Leland adopts such a "nirvana approach" when he shows that certain minimum quality standards may be socially desirable for some markets where initially the market does not internalize externalities at all²⁴. Such a proposition does not hold if the consequences of setting minimum quality standard are compared with those of a real market with positive costs of transaction.

In such a real market, external economies of information are internalized only up to the level where the marginal cost of acquiring information is equated with the expected marginal return. At this equilibrium, there exists no further gain from exchange, although some external economies may remain. So the Akerlof's prediction that the adverse selection principle could lead to the disappearance of the market is really possible if and only if the trading parties are unable to avoid any information costs. In a world with positive transaction costs,

23. Y. BARZEL, "Some Fallacies in the Interpretation of Information Costs", (1977) *The Journal of Law and Economics* 20, October, 303.

24. H. LELAND, "Quacks, Lemons and Licensing: a Theory of Minimum Quality Standards", (1979) *Journal of Political Economy* 87, December, 1334.

this specific case where people do not search for means of minimizing these costs, could only be possible because of the wrong assignment of liabilities between the parties, i.e. because the legal system would not place liability on that party which, in the usual situation, could be expected to reduce it at lower cost. Beyond a certain point, such absence of a market may be interpreted, from an allocative point of view, as a way of avoiding waste, rather than as a sign of failure.

THE NEW QUEBEC CONSUMER ACT

The preceding analysis has described the working of the used car market in an environment of contractual freedom. Both transacting parties negotiated the terms of a contract freely on the basis of the principle of equality and mutual confidence. From the buyer's point of view, this freedom was reflected in the choice of a selection process which was based on his assessment of comparative advantage. It was based on the buyer's as well as the seller's confidence that the Civil Code guarantees such freedom to contract by optimally dividing their respective liabilities. The new Consumer Protection Act radically changes this overall picture. Let us see first what the main analytical elements of the new act are, and second what their consequences on the allocation and distribution of resources are likely to be.

The Consumer Protection Act: An Analytical View

The recent consumers' protection legislation enacted in the Province of Quebec breaks with the philosophy of the Civil Code and generally stands at the margin of the principles of civil law. It tends to attenuate the general principle of contractual freedom and consensualism by imposing mandatory provisions in contracts between consumers and sellers. Moreover, this legislation assigns an increased power to the courts in the contractual activity of the parties.

In specific contracts relating to used cars, the new consumer protection law prescribes that the seller provides a variety of information to the buyer (sections 155, 156, 157 and 158). In addition to the general guarantee inherent in all contracts, sellers have to offer specific warranties of good working. The terms of such warranties are determined by a combination of age and mileage (sections 159 and 160). The used car stock is divided into four classes which are based on a combination of age and mileage. A warranty of good working is mandatory on all contracts of the first three classes. The fourth category is composed of all automobiles too old or with too much mileage to belong to the previous three. This means that freedom to contract continues to

prevail for the consumer who buys a used car of the fourth category. As in the past he will have to find the information production function which minimizes the overall transaction costs to him. It is assumed that all the existing techniques and insurances previously available will continue to exist. Except for cars of the fourth class, freedom to contract is clearly eroded by the new constraints introduced in this legislation. The contracting parties can no longer negotiate the conditions of the exchange. Neither the seller, nor the consumer can negotiate the exclusion of the warranties provided for in the law. Transgression of these provisions are made a criminal offense.

Attenuation of the principle of free contracting is also evident in the general philosophy which permeates the legislation. The new law is clearly more favorably disposed toward the consumer. Consumers may nullify a contract or reduce their obligations thereunder where the respective obligations of the parties are deemed so disproportionate as to amount to exploitation of the consumer or where the obligation of the consumer is thought excessive, harsh or unconscionable (section 8). This contrasts with the philosophy of the Quebec Civil Code which recognizes the equality of the parties (article 1012).

Finally, when faced with ambiguous and doubtful situations, the courts are to interpret contracts in favor of buyers (section 17), in direct contrast with the general principles of the Civil Code which, in cases of doubt, is to be interpreted against whoever has contracted an obligation. Finally, the court, in assessing the respective gains from trade, is to take the social and economic conditions of the parties into account (section 9). In this manner, the terms of exchange are defined by the law, rather than by the parties to the exchange. Exemplary compensatory payments can sometimes be claimed by injured buyers. Cancellation by buyers is also made easier when the latter feels injured, and damages can include losses attributable to the product not providing the expected services.

It is seen that on the whole the new social regulation has as its main consequence the effect of ascribing a greater liability to sellers regarding the quality of their goods and at the same time of conferring new rights and claims to buyers. As such consumer protection legislation in Quebec shows the same general tendency of most legal frameworks in North America to move gradually from the *caveat emptor* principle toward *caveat venditor*²⁵. It is also similar to corresponding

25. It should be emphasized that it is not this change per se that causes inefficiencies, because without transaction costs, *caveat venditor* is equivalent to *caveat emptor*. Inefficiencies or increases in transaction costs occur precisely because transaction costs are likely to be higher under the new regime.

movements elsewhere in the sense that sellers are made liable, not only because a contract has been unfulfilled, but because a wrong was done.

Allocative Consequences

From an economic point of view, the main allocative consequences of these changes are clear: the cost of supplying goods "protected" in this manner has increased, because their quality has increased. This general conclusion is supported by the rise in the price of used cars following the enactment of similar legislations elsewhere. While no data on the price changes are now available in Quebec because the law has just been proclaimed in May 1980, a comparison with the 1974 *New South Wales Motor Dealer Act* which is very similar to the Quebec's Legislation can be made. In this Australian state, the cost of the warranty law has been estimated to add some \$300. to the price of average used car. Are included in this estimate the repairs or the reconditioning of the used car, the charges to cover warranty claims and the usual administration costs²⁶. As a further element of support for this order of magnitude, it should be recalled that extended service warranties offered by some companies prior to the enactment of the consumer protection legislation added some \$200. to the market price of used cars.

A second allocative consequence of new legislations to protect consumers is related to the concept of moral hazard. This concept refers to the tendency of an economic agent (the insured) in a transaction, to interpret to his advantage information not equally available to all (the insurer) and to modify his behavior accordingly. Such negligent behavior by one of the transacting parties is the result not of moral perfidy, but of rational economic reasoning²⁷. Different means have been developed by insurers to reduce it. Firms that offered insurance on used cars encourages self-insurance by providing less than full coverage of all possibilities of defect and also by allowing deductibles. Used cars were also inspected at the date of sale in order to assess the possible defects correctly. In a further way, the relative uniformity of contracts can be interpreted as means of reducing the problems of

26. S. STAR, "Risky Products and Consumer Protection: an Economic Study of Information, Insurance, Warranties and Liability", unpublished manuscript, July 1979, 150-163.

27. K.J. ARROW, "Uncertainty and the Welfare Economics of Medical Care", (1963) *American Economic Review* 53, December, 941-973; M.V. PAULY, "The Economics of Moral Hazard: Comment", (1968), *American Economic Review* 58, June, 531-537; H. DEMSETZ, "Information and Efficiency: Another Viewpoint", (1969) *The Journal of Law and Economics* 9, April, 1-22.

moral hazard. In the Province of Quebec, the Civil Code contributed to economize on moral hazard costs by introducing the concept of "reasonable diligence".

Under the new regime, it is far from certain that the institutional arrangement will prove as effective as the former one in minimizing this phenomenon. All buyers of a classified used car are compelled to buy a guarantee. As it is not easy for a seller to detect a negligent behavior from a random one, the consumer can adjust his behavior by maintaining less precautionary habits. In this manner new and additional costs are imposed on the seller. No individual is motivated to restrain his own behavior optimally, because the incremental cost of his negligence is largely spread over other used car buyers. Therefore he bears only a tiny fraction of the cost of his incautious behavior. Thus the new arrangement does not induce consumers to change their behavior in the way desired by the seller, even though the latter is the one who bears the cost during the warranty period.

In that sense, imposing mandatory warranty does not constitute an efficient institutional arrangement because it does not assign liability on the economic agent who is most able to avoid the cost. To reduce the social costs originating from this liability assignment²⁸, a seller should be allowed to refuse to sell a used car to consumers who are deemed inferior in terms of risks. This proposal is the counterpart of what takes place when a consumer discriminates among sellers and refuses to patronize a seller whose price or product quality are deemed inferior. Since it is illegal for sellers to discriminate among consumers, policing and enforcement costs are increased.

Distribution of Benefits and Costs from Consumer Protection Legislation

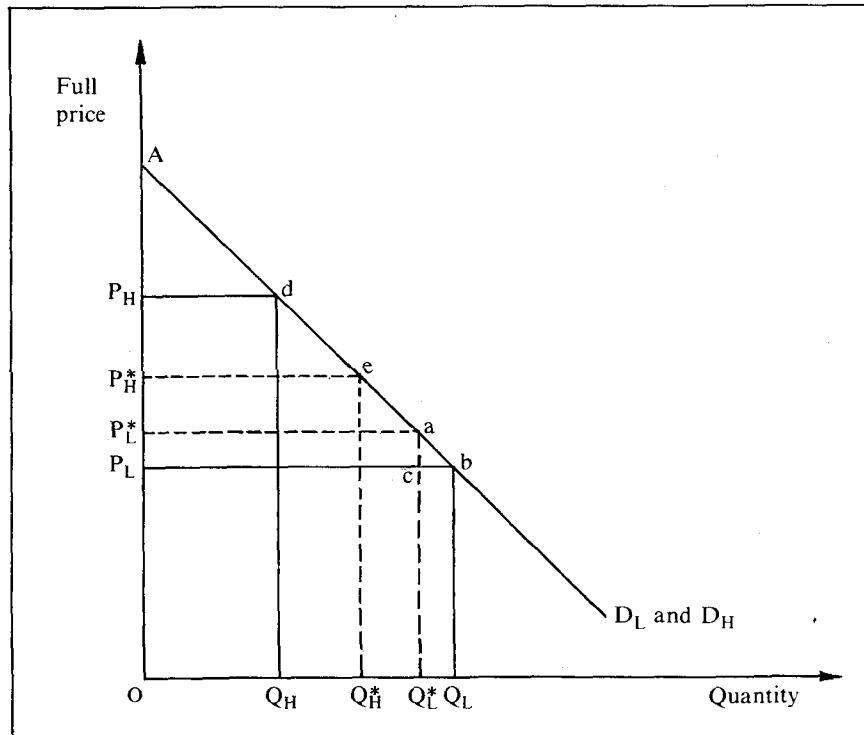
The kind of regulation discussed in this paper sets minimum standards of quality and safety for goods and services traded in the market, and as such raises the price of such goods. This consequence is brought about partly by outright prohibition of low-quality and unsafe goods, and partly by raising the cost to sellers of supplying inferior goods. This will affect various consumers differentially depending on what level of ability they possess in assessing quality and on whether they are risk lovers or risk averters. Let us develop this idea further.

28. G. CALABRESI and K.C. III BASS, "Right Approach, Wrong Implications: a Critique of McKean on Products Liability", (1970) *University of Chicago Law Review* 38, Autumn, 74-91 and 120-122, and W.Y. OI, "The Economics of Product Safety", *loc. cit. supra*, note 1, 19.

D_L and D_H in Figure 1 represent the demand for used cars by two individuals assumed to have similar preferences but different production functions. As argued previously, it is assumed that the population of buyers is composed of consumers with varying types of attitude toward risk and different levels of ability to acquire information. At one extreme, we find consumers who "produce" their desired level of quality at low cost because they possess the technical abilities and the attitudes toward defect risks such that their best production process is full vertical integration. In so doing, they minimize the full price of the goods purchased. This category of buyers can be represented graphically as paying a full price OP_L for a quantity OQ_L of used cars. They are the low-cost consumers. At the opposite extreme, we find consumers who deal entirely in the "market" because they are risk averters and because alternative opportunities make them unable to acquire information at low cost. This situation is represented by full price OP_H and quantity OQ_H in Figure 1. The full price to these consumers is higher because of their low ability to acquire information and bear risks. They are the high-cost consumers.

Consumer protection legislation raises the minimum full price for low-cost consumers to something like OP_L^* in Figure 1. Consumers who previously produced their own information and risk-bearing at low cost are now prevented from doing so by having to buy higher quality, less risky substitutes. Consumer protection legislation thus introduces a sort of tax on low-cost production processes equal to the price differential $P_L P_L^*$ and as a consequence reduce consumption possibilities for the consumers concerned. The value of the surplus lost by consumers of low-quality products corresponds to the area $P_L P_L^* ab$. On the other hand the setting of minimum quality standards reduces the full price of goods not eliminated by regulation to something like OP_H^* . This is due to the fact that dispersion in quality and safety is reduced, since low-quality and less safe goods are withdrawn from the market. The cost of information and of risk-taking for high-quality demanders is indeed rooted in the fact that quality distribution is wide, so that unless they invest in precautionary measures, chances are that they will occasionally fall on low-quality goods. Now consumers' legislation reduces quality dispersion or increases standardization. Therefore to all people with preferences for a level of quality and safety higher than the minimum set by regulation, the cost of obtaining their desired level of quality and insurance is reduced. This increase in consumers' surplus is represented by $P_H P_H^* ed$. High-cost consumers receive implicit cross-subsidies from low-cost consumers.

FIGURE 1
Transfers Associated with Consumer Protection Legislation



CONSUMER PROTECTION LEGISLATION AND THE POLITICAL MARKET

Faced with the apparent fact that consumer protection legislations seem to confer losses on both suppliers and buyers, analysts of the new regulation are generally at a loss to explain measures with no apparent beneficiaries. One of the first analysts of this problem concluded from his examination of this general picture that social regulation represents additional costs for suppliers, without offsetting benefits to them²⁹. In that respect its effects seem to differ from those of sectoral regulation. To most writers these results are difficult to reconcile with accepted theories of government regulation viewed as sources of transfers to factor owners. On the other hand, it has been shown above that substantial transfers can be operated between consumers by such

29. R.A. POSNER, "Reflections on Consumerism", (1973) *University of Chicago Law School Records* 20, 20-25.

legislations. We conclude this paper by attempting to show that such wealth transfers can be legislated by vote-maximizing politicians.

We shall retain most elements of what can be viewed as the accepted framework for the economic analysis of representative government. On the other hand we shall emphasize the role of competition between political parties more than is usually the case in the standard analysis of governments. In that perspective the political market can be regarded as a mechanism resorted to by people for the purpose of transferring rent or wealth in their favor. What is exchanged in this market is transfer policies for votes. Suppliers of policies, i.e. the production agents, are the political entrepreneurs together with the firms that they run, the political parties. Demanders of transfers are the citizens, who offer or withdraw their votes in return for the rent transfers they derive or lose.

If this political market was perfect, i.e. if competition between politicians was strong, no political entrepreneurs could gain votes by offering policies which did not generate welfare gains. The real world is different. To engage with some chance of success in the exchange of votes for transfer policies, citizens must make use of numerous instruments of political action, including lobbying, efforts to acquire information for voting purposes, migration between jurisdictions, membership in social movements, etc.³⁰. Because no one can avoid incurring various proportions of these costs in seeking rent transfers, competition between politicians in the vote market is imperfect.

An important consequence of this state of affairs is that individuals will invest in political activities only until returns are equalized at the margin with those generally available in the economy. This is the simple extension to politics of accepted price theory. And because citizens expect differential benefits and costs from the various bundles of policies offered them, the amount invested by each individual or group of individuals will vary. From the politicians' point of view this means that political entrepreneurs, in their desire to gain votes and secure their election, will supply policies which offer concentrated benefits on some groups and they will distribute the burden widely on other groups. This process will be carried out to the point where policy bundles offered tend to equalize marginal vote gains with marginal vote losses³¹. This condition implies that political entrepreneurs diversify their support.

30. For a further description of those costs, see A. BRETON, *The Economic Theory of Representative Government*, Chicago: Aldine-Atherton, 1974.

31. A rigorous formulation of this process can be found in S. PELTZMAN, "Toward a More General Theory of Regulation", (1976) *Journal of Law and Economics*

Concentrating Benefits on High-Cost Consumers

Now what are the policies most likely to confer concentrated benefits on some groups and small losses on other groups. An important consequence of this logic is that producers will invest more than consumers in political action. Policies will be biased in their favor. The tendency to cartelize competitive sectors through direct regulation, nationalization or protectionism should be more pronounced than the tendency to contain prices in naturally monopolistic sectors. This prediction clearly agrees with the known empirical results. The capture theory of regulation may be an extremist position but it remains more maintainable than the traditional and popular notion that the government's goal is to further the common good and protect the consumers against suppliers' abuses.

It would be incorrect to view social regulation as offering no advantages to factor suppliers. As a result of the higher cost of doing business associated with products liability, occupational licensing and other measures to protect the workmen's health, entry into industry is often made more difficult to potential entrants. Because of this, suppliers in place can gain a competitive edge over potential newcomers. Assuming that these are not negligible consequences, social regulation resembles other varieties of regulation in reducing competition and protecting factor suppliers already in place.

On the other hand the political power function is not reflected exclusively in the domination of producers over consumers. There is also room in the political market for the promotion of the interests of sub-groups of consumers at the expense of other consumers' interests. In operating changes in the price structure through consumer protection legislation, political entrepreneurs find themselves concentrating benefits on high-cost consumers while spreading the burden more widely on low-cost consumers.

Consider the relative position of individuals L and H in Figure 1. They are differentiated by the level of unit cost to incur to acquire a used car, OP_L and OP_H . By virtue of his unit cost being lower, individual L obtains a higher consumer's rent than his less privileged neighbor in an unregulated market of used cars. This opens up opportunities for politicians to gain votes by concentrating benefits on high-cost buyers and diffusing the burden on low-cost consumers. Consider a hypothe-

19, August, 211-240. The idea was also set forth in J.-L. MIGUE, "Controls versus Subsidies in the Economic Theory of Regulation", (1977) *Journal of Law and Economics* 20, April, 213-221.

tical rise of $P_L P_L^*$ in the unit price of a used car to the low-cost buyer.

This represents a relative loss of $\frac{P_L P_L^{*ab}}{P_L A_b}$. 100 percent in his con-

sumer's surplus. Now suppose that the product of such an implicit tax ($P_L P_L^{*ac}$) is transferred to the other buyer in lower prices. While it could easily be shown more rigorously, a simple look at Figure 1 will convince the reader that the relative rent loss of L is lower than the

relative surplus gain to individual H. Something like $\frac{P_L P_L^{*ab}}{P_L A_b}$.
100 percent $< \frac{P_L P_L^{*ac}}{P_H A_d}$. 100 percent. A given relative price rise to

L would permit a higher relative price decline to H. The high consumer's value of individuals like H generates a kind of wealth effect which makes it possible for politicians to transfer part of it to low-surplus consumers and possibly gain their support, without eliciting as much opposition from losers.

In operating changes in the price structure in favor of high-cost consumers, political entrepreneurs find themselves concentrating benefits on some consumers while spreading the burden more widely on others. The equalization of marginal vote gains and losses in an imperfect market requires that cross-subsidization be practised in favor of high-cost consumers. Such transfers elicit more support from gainers than opposition from losers. It could be shown that the political process does precisely that through its various instruments of output standardization. In sectoral regulation standardization is accomplished through direct reductions in the price spread between low-cost and high-cost consumers. In social regulation quality variance and risk are directly reduced by prohibition of low-quality goods. Politically motivated transfers are thus operated in favor of individuals with demand for quality and security (high-cost), while the burden is placed on low-cost consumers³².

CONCLUDING REMARKS

Consumer protection legislation in the Province of Quebec (and elsewhere) brings about an erosion of the traditional neutral rule of

32. For a fuller demonstration of the similarities between the various public sector supply arrangements see J.-L. MIGUE, "Trade Barriers, Regulation and Bureaucratic Supply as Alternative Instruments of Wealth Transfers", in *Non-Tariff Barriers After the Tokyo Round* edited by J. QUINN and P. SLAYTON, Montréal, The Institute for Research on Public Policy, 1982, pp. 103-117.

caveat emptor in favor of greater producer's liability. First of all, mandatory warranty on all classified used cars can be interpreted as a tax on the selection process chosen by buyers who are risk lovers and who have a comparative advantage in the acquisition of information. Those consumers are thus deprived of opportunities to buy low-price cars. Such legislations reduce their consumption set while they offer an implicit cross-subsidy to buyers whose selection process is more costly. As a matter of fact, this sub-group of consumers have their welfare increased because the quality distribution of used cars is reduced and so is their cost of getting information and of risk-taking. It is doubtful that this legislation realizes its allocative goals, namely to compensate for market inefficiencies by supplying a more optimal amount of information. At the same time, it influences the distribution of income by acting as a source of transfers from low-cost buyers to high-cost buyers.