EXPERIMENTAL LAW AND ECONOMICS

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RESEARCH IN EXPERIMENTAL ECONOMICS
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EXPERIMENTAL LAW AND ECONOMICS

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INVESTOR IN PEOPLE

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INTRODUCTION

R. Mark Isaac and Carl Kitchens

Experiments. Law. Economics. Those three words taken by themselves encompass vast parts of the human intellectual experience. Even when we link them together as Experimental Law and Economics, we see a large and diverse body of inquiry over the last half century. We are pleased to add to that body of knowledge with the papers in this volume.

It is not difficult to find the historical and natural linkages among "experiments," "law," and "economics." Christian church patriarch Lactantius in the fourth century A.D. connected the Roman Emperor Diocletian's edict on prices to observable economic outcomes.[1] Adam Smith famously debated the wisdom of laws against people of the same trade gathering together. And, almost 2,000 years after Lactantius, contemporary empirical work on the economic effects of wage controls (the minimum wage) could fill several of these volumes.

So how have "experiments," in the form of experimental economics, joined this mix in the more than half a century since the appearance of Vernon Smith's seminal works? Smith himself points the way in his (Smith, 1981) methodological treatise in which he argues that to see why microeconomic systems can inherently be amenable to controlled experimental testing, we have to review the way we look at economics itself. Smith argued that in that period (the 1960s to 1980s), microeconomics research was being transformed by theorists who rejected a null-institutional version to one in which the "microeconomic system" was composed of both the economic environment and the institutions which mediated preferences and costs into economic outcomes. Once the economic theorist introduced individuals' strategic and behavioral responses into the mix, then economic theory no longer (if indeed it ever did) existed in the rarified mathematical world mapping unobservable preferences and production conditions directly into economic outcomes. In Smith's 1981 work, all of this came together in an argument that economists could and should be able to test under controlled conditions the effects of the "rules of the game" that we call economic institutions.

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Looking back upon the rarified air of the late midcentury, one can see that there were *at least* three revolutions in economics that would make experimental law and economics not only possible but also intellectually exciting. Already mentioned were those microeconomic theorists who began explicitly incorporating institutions into their models (e.g., L. Hurwicz, S. Reiter, T. Groves, and J. Ledyard.) Second was the wave of so-called "new institutional economists" (e.g., R. Coase, O. Williamson, F. Hayek, L. Davis, D. North, G. Libecap) who focused on historical lessons and archival data and records to investigate the role of institutions shaping economic outcomes. Finally, there was the so-called "game theory" revolution in microeconomics which required that the "rules of the game" be spelled out so that equilibrium (and sometimes disequilibrium) predictions could be made.

It goes almost without saying that "the law" is one of the most important institutions of a civilization, and the influence of laws on economic outcomes is just as obvious today as it was in the time of Lactantius. We are not lawyers so we do not have a personal history of legal and philosophical scholarship on why the law is the way it is (or should be) or how laws in a particular time and place come to be. Those are fascinating topics, but we are focused here on experimental and empirical investigations into topics about both the economic effects of the law and also how economic theories can explain the behavior of individuals within a legal system.

Stepping into this incredible intellectual ferment then were the experimental economists whose work in the controlled testing of economic institutions led them quickly into experiments in the realm of law and economics. For example, the paper which laid down the archetypal methodology for conducting experiments with changes in institutions, Hong and Plott (1982), investigates a problem in changes in industry regulations. Other early papers looked at issues in antitrust (Grether & Plott, 1984; Isaac & Smith, 1985). An earlier volume in this series (Volume 9) examined experiments in antitrust, and Wellford (2002) wrote in that volume an essay on how experimental methods could be useful to antitrust professionals.

Since the initial manifestations of experimental law and economics focusing on regulation and antitrust, the portfolio of legal institutions which experimentalists have investigated has expanded. Economics experiments have been used to investigate the endogenous evolution of property rights as described by Ellickson (1989) (e.g., Wilson, Jaworski, Schurter, & Smyth, 2012) and issues in land assembly [see Portillo's essay in this volume]). Even parts of the law itself have been shown to be amenable to experimental testing: examples would include the selection, voting rules, and procedures of juries (Aimone, North, & Rentschler, 2019; Goeree & Yariv, 2011; Guarnaschelli, McKelvey, & Palfrey, 2000) formal rules of arbitration (Ashenfelter, Currie, Farber, & Spiegel, 1992; Dickinson, 2005; Deck, Farmer, & Zeng, 2007) and pre-trial settlement bargaining (Babcock & Loewenstein, 1997; Loewenstein, Isaacharoff, Camerer, & Babcock, 1993; Van Boening & Sivvopoulos, in this volume).

Having become firmly established in the experimental economics tradition, papers in experimental law and economics can and have been published in the

very best general interest journals and in specialized field journals (quite literally in the field journals of almost every field in microeconomics, not excluding journals dedicated to law and economics). What, then, is the contribution of an edited volume such as Research in Experimental Economics? REE has a long history of filling obvious holes in intellectual debates to which experimental methods contribute. Here are some examples. There seems to be a general cry among academics and academic critics that there is too little replication in the social sciences and that journals have a bias against null results (which results in too many clever but unreplicable results). Research in Experimental Economics steps in against both of these problems. We have no problems publishing replication and robustness studies.[2] Likewise, interesting, well formed, experiments will sometimes produce a null result. Null results are an important part of science. But as paper submitters and not just volume editors, we cannot argue that contemporary economics journals have no bias against a null result. At Research in Experimental Economics, we strive to provide a home to all intellectual investigations, whether they produce "clever" positive results or show that a theoretically and obviously anticipated treatment effect simply doesn't happen.

Before the internet, REE was one of the few places where experimental researchers could publish their instructions. Even today, experimental instructions are often relegated to hyperlinks that, for various reasons, may or may not be accessible as time goes by. We actively encourage our authors to include copies of their instructions.

Finally, brevity and simplicity are virtues we teach out students. However, it is sometimes the case that interesting experimental research cannot be distilled in press without hurting the exposition. REE is a welcoming home to those papers (remembering that our referees will, like at any journal will seek clarity and precision in exposition).

How do the set of papers in this volume advance the literature? The papers in this volume follow two long-standing traditions in experimental economics and law and economics. First, the collection of papers here follows the tradition of experimental methodology that allows one to test the potential impacts of alternate institutional arrangements. Many norms, customs, and laws are born out of path dependence, and, as conditions change, alternative rules may open the door for uncaptured economic gains. Laboratory experiments allow researchers to test how efficiency and the distribution of surplus deviates from the status quo set of institutions. In many settings, such as those dealing with the allocation of property rights, it would be fundamentally impossible to isolate the impacts are particular rules given the excessive transactions costs imposed under an alternate set of rules. For instance, imagine how difficult it would be to re-write every deed or mortgage in a given location if the method of land demarcation were changed, or if the underlying system upon which locations were defined, such as latitude and longitude, were reconstructed. Similarly, should aspects of legal procedure be experimented with, for example changes in criminal sentence lengths, and outcomes be affected, one can only imagine the string of lawsuits challenging the validity of the real-world experiment. One can also imagine the outcry from consumer protection groups if firms withheld product quality information from

some consumers, while providing it to others in the name of science. In the real world, policy experimentation is costly, yet, in the laboratory, it is possible to explore many different alternatives, analyze the choices that participants make, and often measure or rank the relative or absolute performance of a given design choice. These findings are useful for advising policy makers and may rule out many institutional choices that would lead to outcomes that may not justify the change in institutional arrangement. Across many broad questions, the experimenter is capable of evaluating contextualized versions of the world.

Secondly, a subset of the papers in this volume, in addition exploring institutional change, follow the tradition in experimental economics of replication and robustness studies. Even small changes in procedure, subject pool, or the communication medium or experimental technology may raise questions of external validity. Two of the papers in this volume explicitly explore how changes in procedure, from pen and paper experiments to electronic interfaces impact previously explored topics. While the move from pen and paper to electronic formats is largely complete, new debates have arisen recently over differences that may arise from in person electronic interfaces to remotely administered experiments.

In terms of the contributions to the law and economics literature, this volume contributes to three key areas. First, two papers in this volume summarize and explore mechanisms to facilitate the assembly of property rights held by many individual property owners, these papers are: "Land-Assembly Experiments: A Survey" by Javier E. Portillo and "Laboratory Experiments of Land Assembly Without Eminent Domain" by Mark DeSantis, Matthew McCarter (in memoriam), and Abel Winn. Secondly, this volume contributes to a growing body of work that explores legal procedure. "Multi-Offer Litigation: An Empirical Analysis of Alternative Mechanisms" by Alexandros Vasios Sivvopoulos and Mark Van Boening explores how different bargaining rules affect the likelihood of settlement failure leading to litigation. "Not as I Do: Hypocrisy Aversion and Optimal Punishment of Common Offenses" by Gregory DeAngelo, Michael D. Makowsky, and Bryan McCannon explores how behavioral factors motivate law enforcement to apply the law. Finally, "The Robustness of Lemons in Experimental Markets" by Blake Dunkle, R. Mark Isaac, and Philip Solimine replicates a classic set of market experiments by Lynch, Miller, Plott, and Porter (1986, 1991) using more recent experimental methods to understand how different market rules affect market outcomes in markers with asymmetric information. Each of these papers contributes to one of the broader areas within experimental law and economics.

In 2005, the Supreme Court of the United States issued its decision in *Kelo* vs *New London*, upholding the right of the defendant to use takings clause of the 5th amendment in the US Constitution to acquire properties via eminent domain. Under the 5th amendment, two key tests must be satisfied to utilize eminent domain. First, properties acquired via eminent domain must be paid *just compensation*, which has often meant fair market value in the courts. Secondly, the property in question for acquisition by a government agency or party acting under the authority of a government, can only acquire the property if it is for a *public purpose*. In *Kelo* vs *New London*, the legal challenge came on the grounds that the

acquisition, or taking, was not for a public purpose, as the property in question was meant for a private redevelopment that would indirectly increase property taxes. Since *Kelo*, legal scholars and economists have sought to clarify when eminent domain is justified (see Miceli, 2011 for an overview), or alternate means by which individual properties can be aggregated. "Land-Assembly Experiments: A Survey" by Javier E. Portillo lays out the basic justification for eminent domain. Individual property right holders have the ability to extract monopoly prices from developers, which may result in expenditures in excess of the value of a proposed development. Thus, in this case, the externality created by disaggregated ownership results in smaller or less frequent aggregations. Since *Kelo*, the question most frequently asked by economists is whether alternate mechanisms of bargaining alternatives can overcome this so-called holdout problem. Portillo summarizes many of the key papers that have emerged in the literature, classifying them into groups that study highly structured bargaining rules that directly test a particular bargaining theory, those that are less structured and tied to theory, allowing for more free form bargaining, and those that alternate mechanisms. Out of the existing literature, a few patterns emerge: across many papers, the authors are able to create conditions that generate holdout behavior. Secondly, several institutions alleviate the holdout problem including but not limited to contingent contracts, options contracts, and methods that induce competition amongst landowners, such as multiple development locations, or smaller property requirements to successfully aggregate.

A key advantage of laboratory experiments is that they allow researchers to explore mechanisms and designs that would be otherwise difficult to implement in the real world. In this volume, "Laboratory Experiments of Land Assembly Without Eminent Domain" by Mark DeSantis, Matthew McCarter (in memoriam), and Abel Winn provide an illustration of how laboratory experiments are useful to study the land assembly problem. DeSantis, Winn, and McCarter are interested in understanding solutions to the holdout problem that is ubiquitous in land assembly. Drawing on the public finance literature, they suggest a tax mechanism to facilitate land assembly. In this mechanism, landowners must declare a valuation for their property. As their declared value increases, the probability that their land is acquired by a public agent declines. Intuitively, landowners have an incentive to declare the value of their property as infinitely valuable. To counterbalance this incentive, property owners are required to pay property tax on their declared value according to a complex function. Plassmann and Tideman (2008) proved that this mechanism results in truth telling. The government then has the option to purchase the property at the declared value. In theory, the ability to buy property at its true value eliminates the holdout problem and encourages land assembly. This is exactly where laboratory experiments shine. To implement this mechanism in the real world, collect data, and evaluate the institutional design there would be many roadblocks. First, the researchers would have to convince political actors to alter their tax law, and property owners would have to be extremely knowledgeable of their property's value. The transition cost to the new tax regime could be very costly, let alone, it would take years of observation to study. Yet in the lab, the experimenters are free to vary institutions and

collect data at relatively low cost. The authors find evidence that their mechanism encourages assembly. Furthermore, the original theory, proposed by Plassmann and Tideman (2008) relies on a complex function that maps declared values into property taxes. The flexibility of the laboratory allows the authors to relax the complexity and asses to impacts of a more general mechanism with a flat tax. They find that even with a simpler structure, that assembly rates rise. This experiment provides some guidance to policymakers in terms of alternative arrangements that may encourage development.

Next in the volume are two papers that address the legal process. First "Multi-Offer Litigation: An Empirical Analysis of Alternative Mechanisms" by Alexandros Vasios Sivvopoulos and Mark Van Boening explores how asymmetric information held by Plaintiffs and defendants in a legal context affects the likelihood of a pretrial settlement. In many legal cases, it is difficult for a defendant to discern the legitimacy or the extent of damages claimed by a plaintiff. In the context of a screening game, under certain conditions, some litigation is optimal. That is, defendants may offer plaintiffs low settlement values, knowing that those with weak claims will settle, leaving the courts to assess damages in cases where claims are legitimate. In the analogous signaling game where plaintiffs make pretrial settlement offers, those with weak cases may try to masquerade as individuals with legitimate claims. Here litigation will also arise because the defendant cannot credibly discern who was a legitimate claim. Prior work by Pecorino and Van Boening (2018) showed that despite the clean theoretic predictions, there was still excessive litigation in both of these games. Sivvopoulos and Van Boening extend the analysis by trying to understand the root causes of the bargaining failure. To extend the analysis, the authors introduce new treatments whereby plaintiffs can make multiple offers in the signaling game, and where defendants can make multiple offers in the screening game. The authors also moved beyond the take-it-or-leave-it offers common in bargaining experiments to allow for a richer environment with alternate offers made by both the plaintiff and defendant. These moves toward a more realistic bargaining environment highlight that a lot of the observed excessive litigation in the take-it-or-leave-it environment is mitigated. In other words, the ability to send and receive multiple offers transmits some information that is useful in reaching a settlement. Finally, the chapter offers a methodological test of the mediums used in experimental economics. Today, many experiments in the economics literature are conducted via computer interfaces. Sivvopoulos and Van Boening migrated the Pecorino and Van Boening (2018) pen and paper experiment, and replicate many of their findings using different experimental technologies. This provides some sense that the format in which the data are collected does not interact with the research question.

The second paper that examines the legal environment, "Not as I Do: Hypocrisy Aversion and Optimal Punishment of Common Offenses" by Gregory DeAngelo, Michael D. Makowsky, and Bryan McCannon asks how one's personal experiences with the law influence one's enforcement of the law. As an example, consider a police officer that routinely speeds when off duty. This individual, who in their professional life is tasked with enforcing the law, may, in their private life, routinely violate the law. For some individuals, this may create a sense of

hypocrisy, and raises questions regarding how those individuals will enforce laws in their professional life that they either routinely violate or previously violated in their youth. If the experience of hypocrisy affects an individual's payoff, then the changes in the severity of punishment may have unintended consequences. In the context of the speeding example, if the fines levied increased by a large factor, then officers, who themselves speed, may be less willing to pull over speeding drivers because they feel bad about the punishment they are about mete out. As with all of the papers in this volume, exploring how individuals respond to a sense of hypocrisy, and whether the effect of hypocrisy can be isolated from other factors in the field lends itself to a laboratory environment. The authors provide a clever experimental design to isolate the hypocrisy effect as penalties increase, finding that as officers enforce the law less often as the penalties and punishments increase. This insight may be especially important, as many of the duties carried out by police are routine and mundane, very different from the many police dramas on television.

Finally, the last chapter in this volume, "The Robustness of Lemons in Experimental Markets" by Blake Dunkle, R. Mark Isaac, and Philip Solimine revisits classic market experiments by Lynch et al. (1986, 1991) where buyers are unable to observe the product quality offered by sellers. Following the classic work of Akerlof (1970), the low-quality goods will push the high-quality goods out of the market because of the information problem. Institutionally, this raises the question of whether policy makers should intervene, for example by requiring a warranty or third party testing and certification, such as UL, a private safety certification company. Alternatively, many scholars have adopted the static Akerlof framework into a dynamic setting and have shown that under certain conditions, reputation building may be able to offset the lemons problem. Lynch, Miller, Plott, and Porter and here, Dunkle, Isaac, and Solimine, explore whether reputation building is possible in the market environment as a means to overcome the information problem. Dunkle, Isaac, and Solimine broadly replicate the findings of Lynch, Miller, Plott, and Porter by demonstrating that sellers are unable to credibly build a reputation in this market environment. Importantly, they demonstrate this finding using a new medium (computer interface) and slight changes to experimental procedures that more closely align with best practice in contemporary experimental economics. This sets the stage for future testing of mechanisms that may overcome the lemons problem.[3]

As usual, we would like to offer our thanks to the many people who helped in the refereeing process. And, in particular, we offer our most sincere gratitude to the editors and staff at Emerald Press who worked with us with great patience as this volume was completed throughout the Great Pandemic.

NOTES

1. Lactantius criticized Diocletian's edict on prices saying that "men were afraid to expose aught to sale, and the scarcity became more excessive and grievous than ever, until, in the end, the ordinance, after having proved destructive to multitudes, was from mere necessity abrogated." This translation from *Of the Manner in Which the Persecutors*

Died is by J. Vanderspoel and is available at his academic website https://people.ucalgary.ca/∼vandersp/Courses/texts/lactant/lactpers.html.

2. In informal discussions such as in the popular press, the term "replication" is often used for both. In fact, a robustness study is quite different on purpose than that of a replication study. Consider the following: suppose that under controlled experimental conditions Ω, researchers "I" find that a change in institutions or environmental conditions within institutions from A to A′ produce a specific result. One can argue that at one extreme a pure replication exercise seeks to replicate Ω as close as possible to see whether the same results reproduce, i.e., to see whether the initial results were due to some underlying chance that only replicates a small percentage of time. A *robustness* study, on the other hand, is more concerned with whether small but reasonable perturbations of Ω to Ω' will yield the same result. There are numerous examples of these types of perturbations; one obvious one would be the change from one type of market interface to another. See for example Dunkle, Isaac, and Solimine in this volume.

3. A referee for the volume served as guest editor on the Dunkle et al. paper.

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