Book Review of "Inflation and the Enforcement of Contracts" (Renner, 1999)

Schmitz, Patrick W.

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"Inflation and the Enforcement of Contracts" (Renner, 1999)[*]

Patrick W. Schmitz

University of Bonn, 2000

This book, which is based on the author's J.S.D. thesis, discusses the question of whether and to what extent contract law should take an increase in the general level of prices into account. In the Introduction, Renner argues that the core of the problem is whether and under what terms contracts should be enforced during inflation. While this is a substantial problem, it is only a subsidiary question of methods what the principle of enforcement necessitates regarding the adjustment of damages for breach of contract (protecting expectation, reliance, or restitution interests) during inflation.

In the first chapter, Renner describes the experiences of several civil-law countries (Germany, France, Argentina, Brazil, Chile), the United States (a common-law country), and Israel (now employing civil-law doctrines, but having a common-law tradition). The author finds a number of common trends. Under low-grade inflation, intervention by the legal system is limited to particularly problematic long-term transactions. Under chronic double-digit inflation, relief through foreseeability-related doctrines is problematic. Under hyperinflation, courts offer large-scale relief based on equitable doctrines, proceeding on a case-by-case basis.

Renner then examines the question whether contracts should be enforced during inflation from two different starting points. First, in Chapter 2 the problem is analyzed from an economic perspective. According to the Law & Economics literature, parties are assumed to make Pareto-efficient contracts, which should be enforced since this maximizes the contractual parties' total wealth. However, due to transaction costs the parties will not allocate the risk with respect to all future contingencies. Contract law can reduce transaction costs by

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providing a set of terms that the parties probably would have provided if they had written a complete contingent contract. Renner argues that inflation represents a risk different from any other risk. The parties' willingness to offer or receive a price with respect to a particular transaction depends upon their wealth, and hence upon the way in which their wealth is affected by inflation. The cheapest insurer, i.e. the party who should bear the risk in the absence of a contractual risk allocation, is not only determined by the parties' risk attitudes and abilities to foresee the risk, but also by the correlation of other incomes and outgoes (that are unrelated to the particular transaction) with inflation. Renner argues that the importance of the ability to foresee diminishes with the rise in the rate of inflation and that wealth correlation with inflation depends upon the level of indexation throughout the economy. The author then applies the analysis to different kinds of transactions and finds that the experiences reported in Chapter 1 are consistent with the analysis.

In Chapter 3 the problem is analyzed from a second starting point, namely the distributional approach to contract law, according to which the law of contracts must take considerations of distributive justice into account. The author argues that the lower income class loses, under all types of inflation, in comparison with at least one other income class. Hence, as is argued in Chapter 4, while under certain circumstances from the economic analysis viewpoint it might be efficient that the poor bear the risk of inflation, this may be deemed undesirable from a distributional approach to contract law. Finally, in Chapter 5 the institutional competence of judicial and legislative bodies to deal with the problem of contract enforcement during inflation is briefly discussed. It is argued that since one must consider the effect of inflation upon the wealth of individuals in order to design contract rules regarding inflation, whenever possible legislators rather than courts should design such rules.

I think that Shirley Renner has written a very interesting book on an important subject. The chapter I liked most is Chapter 1. The author has diligently studied the relevant sources (there are nearly 200 footnotes in Chapter 1) and describes the experiences of different countries regarding the legal consequences of contracts during inflation in a very readable way. Particular emphasis is put on the German experience in the wake of World War I. This excellent chapter is definitely very valuable for anyone who is interested in the problem of contract enforcement during inflation.

It may well be that the remainder of the book is equally recommendable for students of contract law. However, I think that economists who are interested in the economic theory of contracts (in the sense of Hart and Holmström, 1987) will not be completely satisfied by the analysis. One important topic that unfortunately is hardly discussed is the question why the parties should fail to allocate the risk of inflation, i.e. why contracts should be incomplete in the economic sense (see Triole, 1999). It does not seem to be very complicated or costly to include a clause which links transfer payments to the increase in the general level of prices. In this context, Renner mentions unforeseeable contingencies. Recently the issue of unforeseeable contingencies has been a focus of research in the theory of incomplete contracts (see Maskin and Tirole, 1999). It has been argued that unforeseeability might be inconsistent with a framework that otherwise presumes rationality and that instead indescribability may be the relevant problem. Yet, it is not clear why indexation could lead to any indescribability problems. Moreover, one could argue that particularly in the case of chronic double-digit inflation, when the economy is quite adjusted to inflation and everyone is clearly aware of the possibility of indexation, the fact that a contract prescribes a nominal transfer payment only might well indicate that the parties have deliberately allocated the risk to the payee (perhaps by choosing a relatively high nominal price), contradicting Renner's argument for a general rule of adjustment in this case.

The problem with a purely verbal analysis is that it is difficult to see what assumptions are necessary or sufficient for the conclusions. To be sure, I think that most people would find most of Renner's arguments quite reasonable. However, an economist who is used to formal analysis might feel uncomfortable when reading sentences like "I feel that the following general conclusion is quite accurate" (p.51). While most of the conclusions are in accordance with common sense, it is not easy to find sufficiently precise arguments (particularly in Chapter 3) that could readily be transformed into a formal economic model.

Hence, form an economist's point of view, the main achievements of this book are the identification of an important research topic and the very well-written description of how different legal systems undergoing different types of inflation have dealt with the problem of contract enforcement. While Renner does not offer a formal analysis within a precise model, the book will undoubtedly be helpful for anyone who wants to perform such an analysis.

References

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