JOURNAL ARTICLE

# Should Consumers be Permitted to Waive Products Liability? Product Safety, Private Contracts, and Adverse Selection

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## Abstract

A potentially dangerous product is supplied by a competitive market. The likelihood of a product-related accident depends on the unobservable precautions taken by the manufacturer and on the risk type of the consumer. Contracts include the price to be paid by the consumer ex ante and stipulated damages to be paid by the firm ex post in the event of an accident. Although the stipulated damage payments are a potential solution to the moral hazard problem, firms have a private incentive to reduce the stipulated damages (and simultaneously lower the up front price) in order to attract the safer consumers who are less costly to serve. The competitive equilibrium—if an equilibrium exists at all—features suboptimally low stipulated damages and correspondingly suboptimal levels of product safety. Imposing some degree of tort liability on firms for uncovered accident losses—and prohibiting private parties from waiving that liability—can improve social welfare. (*JEL* K13, K12, L15, D82, D86).



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