3. Economic analysis of public law: to the Coase theorem and beyond

Rational choice theory begins with a sad reality: that of the scarcity of resources. But the flaws of rational action lead to another, equally unpleasant truth. Free transactions do not guarantee happiness in all circumstances. The manifesto of Adam Smith does not create a perfect framework for ideal choices in the interest of everyone. In a nutshell, we cannot fully confine ourselves to the Agora.

At this point, economic theory turns to the legal phenomenon. Can perhaps 'Law' be a remedy for numerous market failures, transaction costs and irrational behaviours? Is it preferable to intervene correctively in horizontal relationships, a function that societies entrust to the State and the law? The answer is extremely important for public law, which is none other than 'the law of the Demos': the point where both the State and the law intersect.

1. WHICH ROLE FOR PUBLIC LAW? FROM PIGOU AND KEYNES TO COASE

1.1 Law, Public Institutions and Institutional Economics

The State and public law have both been concerns of economic theory across time. Such studies come under the headings of 'public' and 'institutional' economics.[1] Their starting point is the following: economic systems do not function independently of the institutions (political, administrative, legal, moral, cultural or social) within which they develop.[2] Following the definition set out by Douglass North, institutions are 'humanly devised constraints that structure political, economic and social interactions'.[3] Both the State and the law are *formal* institutions;[4] they use 'formal constraints', such as legal sanctions or

[1] One of the first scholars was John Commons (*Commons* 1924). We have already cited Thorstein Veblen, John Kenneth Galbraith and Kenneth Arrow. See also *Van de Ven* 1993; *Mackaay* 2000; *Ménard/Shirley* 2018.

[2] *Rodrik et al.* 2004.

[3] *North* 1990, 2010.

[4] As opposed to 'informal' institutions which use other types of moral and behavioural codes. The individuals agree to abide by the values of the 'family', the 'clan', the

public force, to reduce the uncertainty of everyday life and provide stability. Institutions impact economic relations through their existence and evolution.[5]

For example, bankruptcy rules affect the behaviour of firms and investors. Amendments in the bankruptcy code – something that occurs periodically, since legal institutions are constantly changing – alter the strategy of economic players. They adapt their tactics depending on whether the procedure is easy to implement; whether the institutional creditors (banks and tax authorities) hold a veto right or not; who appoints the administrator of the bankrupt entity, and so on. These rules affect whether someone will begin a business activity, receive or grant credit or invest in an existing firm.

Public law mainly governs 'non-consensual', vertical institutions – those that have the authority to impose their decisions irrespective of the acceptance of those concerned. Institutional economics have shown that non-consensual institutions (the Demos) have a crucial impact on horizontal, consensual institutions (the Agora). They influence or even determine from above the behaviour of all persons, natural or legal. Their effects concern not only narrowly economic relations, but also political action, social structures, even moral and sexual choices. Will I be an organ donor? Is it 'wise' to have a child out of wedlock or to make my sexual identity public? Those choices depend in large part on how they are treated by law (if the legislator grants equal legal status to all children irrespective of marriage, if some erotic relations constitute criminal offences, and so on). The approach of institutional economics tries to be neutral and objective – simply to explain why institutions are so important, without judging them.

Economic analysis of public law is closely related to the broader field of institutional economics.[6]

1.2 Welfare Economics in the First Half of the Twentieth Century; the Presumed Beneficial Intervention of Law and State

1.2.1 Arthur Pigou

The British economist Arthur Pigou[7] was one of the first to support the idea that law and public interventionism are the appropriate means for remedying the imperfections of the market. Pigou connects the role of the State to the existence of externalities in transactions. Since negative externalities generate social cost, there is need for an external action to 'internalise' that cost in the

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'club' (athletic, cultural or ecological) and the 'moral majority' or 'minority' to which they decide to belong.

5 *Acemoglu et al.* 2005; *Alesina/Spolaore* 2003.

6 *Katz* 1998; *Mercuro/Medema* 2006; *Parisi/Rowley* 2005; *Shavell* 2004.

7 *Pigou* 1920; *Aslanbeigui/Oakes* 2015.

name of the general interest. That action, usually implemented through the use of public force, aims at ensuring that the price of the transaction serves social welfare. It consists of legal obligations, which assume many different forms, more or less restrictive of freedom in transactions: civil liability rules, taxation to restore social cost, administrative formalities (permits) or prohibitions for specific activities, incentives to promote positive externalities. For example, EU environmental law provides for specific rules on liability and licensing, 'ecotaxes' for harmful activities and subsidies for 'green' energy production.[8]

1.2.2 John Maynard Keynes

John Maynard Keynes[9] studied the macroeconomic defects of the market economy. The Keynesian view is that State intervention is necessary due to the systemic limits of *laissez-faire.* Public authorities shall use the appropriate tools (including legal norms) to shape, create, redirect or even substitute economic relations. In times of crisis – Keynes had in mind the crash of 1929 – the best way (in his view) to counter recession and unemployment is to strengthen the role of the State and apply public interventionism: acquisition and bail-out of businesses, massive recruitment, public entities and monopolies, public construction of infrastructures and production of goods. These policies should be accompanied by rules that set maximum or minimum prices and protect workers (guaranteed salary, prohibition of lay-offs).

1.2.3 The self-evident value of public law and State intervention

Pigou placed emphasis on legal tools for delineating transactions and markets. Keynes went one step further; he praised the leading role of the Demos for correcting, restricting or even replacing the Agora. The above approaches offer a first economic justification to State interventionism and public law. They qualify them as indispensable 'top-to-bottom' mechanisms to regulate human behaviour through constraint and to organise non-consensual institutions. According to these views, the economic superiority of public law relies on the imperfections of rational action. Such inefficiencies prove the self-evident necessity of public law tools. In other words, public intervention is useful because consensual institutions are deficient and inadequate. This

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[8] See Directives 2004/35/CE of the European Parliament and of the Council of 21 April 2004 on environmental liability (OJ L 143, 30.4.2004, pp.56–75), 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity (OJ L 283, 31.10.2003, pp.51–70) and 2009/28/EC of 23 April 2009 on the promotion of the use of energy from renewable sources (OJ L 140, 5.6.2009, pp.16–62). For environmental taxation, see *Backhaus* 1999b; *Williams* 2017; *Ciocirlan/Yandle* 2003 and *Brooks et al.* 2009.

[9] *Keynes* 1964 (1936); *Davidson* 2007.

view remained the prevailing economic analysis of the legal phenomenon for decades. Even today, many national legal orders, at least in Europe, rely on the axiom that State intervention is always beneficial, and express serious reservations as to the capability of private initiatives to serve the general interest.[10]

The teachings of Pigou and Keynes have an undisputable value: they made it clear that it is necessary to cure market failures 'from above'. They are even more important in times of crisis. Restarting the economy after a lockdown – such as the recent, almost global one due to the pandemic – needs serious help from the 'visible hand' of public intervention and makes Keynes fashionable again (up to a certain extent, at least). Nevertheless, in their initial, 'agora-phobic' version, those theories also became the background for a maximalist, over-interventionist, paternalistic and, therefore, inefficient public law.

1.3 Nothing Is Self-Evident about Law: Ronald Coase's Theorem

The publication of an academic article by Ronald Coase forty years later challenged this idealised view of law and State. 'The Problem of Social Cost' (1960)[11] is the most widely read text in two academic disciplines, law and economics. It is also the starting point of modern economic analysis of law. Coase questioned – successfully, according to economists[12] – Pigou's approach to the significance and frequency of externalities. By doing so, he questioned the self-evident therapeutic function of legal intervention to consensual transactions.

Coase's idea, known as the Coase theorem,[13] is simple and disturbing for lawyers who believe in the unquestionable value of legal institutions. According to Coase, *if transaction costs are equal to zero, it is immaterial to which party (of a transaction or a dispute) the law awards a specific right; that right will end up going to the party that values this right higher in economic terms.*

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[10] See Chapter 7, section 2.1.

[11] *Coase* 1960; *Medema/Zerbe* 2000; *Mackaay/Rousseau* 2008.182.

[12] Coase's iconoclastic thinking was not easy to digest. In view of the publication of his article at the *Journal of Law and Economics*, Coase was invited to defend his positions in Chicago, before economists of the importance of George Stigler and Milton Friedman. When the debate started, Coase had to face 20 academics who believed in Pigou's theories. At the end of the evening, it is said that all 21 participants adopted the views of Coase: *Ogus* 1998.

[13] For a full view on the theorem and on Coase's remarkable work, see the articles collected by *Ménard/Bertrand* 2016 and by *Posner/Parisi* 2013. See also *Friedman* 2000.44; *Buchanan* 1973; *Stigler* 1966.213, 1989; *Demsetz* 2003, 2011; *Calabresi* 1991; *Cooter* 1982; *Wood* 2011; *Bertrand/Destais* 2002; *Kahneman/Knetsch* 1990; *Macey* 2010; *Parisi* 2003, 2005; *Siegel* 2010.

1.3.1 Law shall be a tool to reduce, not generate, costs

Let's examine the above declaration through the case study that Coase used in his article. A confectioner and a doctor have their premises in two adjacent plots. They co-exist harmoniously until the confectioner, whose business is flourishing, decides to install more disruptive machinery. There are two potential solutions to this conflict: either one which proves adverse to the confectioner (prohibition to undertake this new activity or obligation to build noise-proof walls); or one which is adverse to the doctor (obligation to suffer from increased noise pollution or to move his office away). Coase analyses all the subsidiary scenarios for this question: 'To whom shall law recognise a right? Shall it grant to the confectioner a right to generate noise or protect the doctor's right not to be bothered by noise?' Coase explains why this legal question is irrelevant. If the confectioner is willing to pay more to continue operating, he will 'buy' that right even if the doctor wins the case before the courts. The doctor will do the same, if he has a sufficiently high (economic) incentive to preserve quietness. In short, by awarding the right to either of the two, the law and the courts do not appoint the party that will continue operating. They solely decide on whether there will be further negotiations and transactions, at the initiative of the party that is not legally awarded the right but which values it more highly in economic terms.

Does this mean that law is useless? No, Coase does not say that. Law would be immaterial, even detrimental, only in conditions of 'zero transaction costs'. Such a situation would exist if the doctor and the confectioner could reach an agreement without information asymmetries, without harming third parties, without using lawyers or other agents, without facing other problems of bounded rationality. This, though, is impossible in practice. Read differently, Coase's theorem acknowledges that legal institutions play a crucial role: when transaction costs do exist, the correct attribution of rights by law is necessary to reduce them and create the optimal conditions for the transaction. If the confectioner and the doctor are not able to work out an ideal agreement (or any agreement at all), the intervention of the law is valuable. According to Coase, law's function is to open the way for the most efficient choices; those that would prevail in the absence of transaction costs. Law is neither self-evident nor always beneficial. It may work in the 'wrong' way, either because there are fewer transaction costs than those estimated by the legislator and the courts or because it promotes choices that fail to reduce them in the most efficient way. In such circumstances, instead of curing failures, it blocks optimal resource allocation. *Inefficient law is itself a transaction cost.*

1.3.2 Public law revisited under the Coase theorem

The Coase theorem considerably influenced the perception of private law in the US. It offered original answers to questions of substance and procedure.

Its importance for public law is less obvious at first sight. The confectioner vs doctor example may appear incomprehensible to those who teach or practice public law. Both neighbours require one or several administrative permits to operate lawfully in their respective premises. Public authorisation is necessary for grounds of town planning, public hygiene or protection of the environment (including noise nuisance issues). Such issues are closely related to the general interest; they cannot be left to the private individuals involved. If the confectioner does not respect the relevant zoning rules or noise standards, he cannot acquire 'a right to operate' – not for all the money in the world.

Does this mean that public law is the worst form of transaction cost, setting unsurmountable obstacles to a potentially beneficial transaction? Not at all. By preventing a series of harmful private behaviours, public law intervenes as a means to reduce transaction costs.[14] Its *raison d'être* is – or should be, according to Coase – to minimise costs; to promote horizontal transactions that serve social welfare. The various regulatory obligations by which the confectioner needs to abide are vital for many reasons. They ensure the harmonious co-existence of different activities and eliminate potential disputes arising from conflicting businesses. A confectioner located in a zone suitable for such a business and equipped with an environmental permit setting the permissible noise levels does not need to enter into any negotiation with any neighbour. Otherwise, the interactions with all others located nearby would increase the cost of running the business. Transactions with neighbours are exposed to several problems: increased research and negotiation costs, information asymmetry (each neighbour will prefer not to reveal the characteristics of its property or business), agency costs (bargaining via lawyers or intermediaries), collective action (each neighbour can blackmail the confectioner to obtain a bigger benefit), cognitive blunders due to bounded rationality (endowment effect when calculating the value of the properties involved). Public law is beneficial for the medical practice as well. The doctor will block the nuisance by invoking zoning or noise regulations; if the latter are not in his favour, he will transfer the property to the confectioner or to another similar business. He will move his practice to a location where noisy activities are prohibited and not run the risk of another noisy establishment appearing next to his office.

In conclusion, the Coase theorem does not reject public law. It partially confirms the approach of neoclassical economics. Public law may indeed offer *systemic legal certainty* – a vital factor in reducing transaction costs. With a crucial difference: the Coase theorem is less naïve regarding the existence of externalities and the need for State intervention. Two conditions need to be met: first, that there are transaction costs; second, that public law can

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[14] *Bertrand/Destais* 2002.

efficiently reduce such costs. It is worthwhile to examine this last point more closely.

1.3.3 Coase's fundamental lessons on the characteristics of public law

The Coase theorem changes everything.[15] It reveals the dual nature of public intervention, as a mechanism that may reduce but also generate costs. It describes public law in terms of cost and benefit. Public law must always prove its efficiency. The impacts of public action should be calculated to confirm its necessity. After Coase, the 'public law-maker' has three options. First is to leave a specific activity unregulated (the 'absent State' option). Second is to impose the outcome on which private individuals would agree if there were no transaction costs: the 'State as imitator of the ideal market'. This is the preferred option for Coase. Third is to impose a solution other than the one that would arise consensually, but only exceptionally and to the extent that this proves necessary in the name of a broad definition of social welfare.[16] This option leaves room for a 'market-oriented (agora-centric) State paternalism'. Is this last form of public action compatible with the theorem? I think so (even if Coase himself would disagree). It respects the superiority of the markets and consensual transactions, as Coase asks. It allows for exceptional State interventions,[17] after assessing their efficiency in pursuing social welfare.

I shall try to apply the above thoughts on Coase's case study. Are all forms of public regulation on the confectioner's activity equally necessary for the general interest? Shall they be equally restrictive? It seems not. On the one hand, zoning and safety rules produce a 'systemic' benefit for social welfare. It is more efficient to impose strict zoning obligations; otherwise, there will be no legal certainty to promote rational use of land, to protect property rights and to reduce transaction costs arising from opportunistic behaviours. Strict hygiene and safety rules are equally important; they should not be left to negotiation between private individuals. Any transaction aiming at non-compliance (an employer paying the workers not to denounce the lack of safety measures) involves severe externalities: increased risk of work accidents, unfair competition against businesses that comply with safety rules. On the other hand, noise nuisance rules do not need to be equally 'hard' and paternalistic. Why not let a beach bar in Mykonos compensate the neighbours for playing loud music? Having said that, it is important to stress that full deregulation is not the best

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[15] *Mercuro/Medema* 2006.

[16] See Chapter 2, section 2.2.3.

[17] Exceptional does not always mean rare. There are fields where intervention must be systematic (quality standards, regulation of liberalised public utilities).

option either; the absence of regulatory standards on noise thresholds would create legal uncertainty.

To summarise, both components of the Coase theorem are crucial for public law. On the one hand, by insisting on the importance of reducing transaction costs, it explains why public intervention may be necessary. On the other, by explaining why the attribution of rights is irrelevant in zero-cost conditions, it makes us think twice before undertaking such an intervention. We must be grateful to Coase. He raised the question of whether public law is useful and linked the answer to the extent of its efficiency.

2. ECONOMIC ANALYSIS AND PUBLIC LAW AFTER COASE

Coase and his theorem boosted the study of law through economic instruments. Coase is in a way the founding father of the new Chicago School, which aspires to play a leading role in the sector. However, there are also other itineraries for law and economics to meet. Various and often conflicting academic movements co-exist in the prosperous fields of economic analysis.[18] Classifying them is a difficult, if not misleading, task. The only relatively safe distinction is the one we applied in the first chapter.[19] It is based on two criteria: whether those schools use economic methods to support a positive or a normative analysis of legal institutions; whether they adopt a narrow or a broad definition of social welfare. The second criterion is significant for public law. Identifying welfare exclusively with economic efficiency leads to a more inimical attitude towards the State (section 2.1). A broader definition extends State functions; it makes economic analysis of law a means to improve rather than to reject public institutions (section 2.2).

2.1 Stressing the Problems of Public Intervention

2.1.1 The Chicago and Austrian Schools of economics

The most notorious critic of public law is Richard Posner, the author of a book that has become, since 1972, the 'bible' of law and economics.[20] Extending the Coase theorem, Posner puts everything, from economic relations to sex[21]

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[18] For such a variety of methodologies in economic analysis of law, see *Parisi* 2004, 2017a; *Ulen* 2017. A historical approach on how law and economics evolved can be found in *Parisi/Rowley* 2005; *Cohen/Wright* 2009 and *Butler/Klick* 2018.

[19] See Chapter 1, section 1.2.

[20] *Economic Analysis of Law*, 9th ed., 2014. *Posner* 1973, 1975, 1987c.

[21] *Posner* 1994. Another Nobelist, Gary Becker, attempted an economic analysis of the criminal system (1968) and of marriage (*Becker* 1973, 1974).

– public law included[22] – under the spotlight of rational choice and microeconomics.[23] Posner and the Chicago School[24] prefer common law as opposed to codified public law. They consider a praetorian legal mechanism to be more efficient, since it produces customised solutions through *ad hoc* court decisions resolving horizontal disputes, which private parties choose to submit before a judge. It has, therefore, the advantage of improving spontaneous transactions, rather than substituting for them. Common law judges may formulate legal solutions that imitate the market; by choosing the most 'efficient' rule, they award rights in accordance with the Coase theorem.[25]

For the Chicago School – as for Ludwig von Mises and Friedrich Hayek, the most prominent representatives of the Austrian School of Economics[26] – public interventionism distorts the market instead of imitating it. It awards rights on the basis of less effective criteria than their economic efficiency. 'Blackboard' economics[27] fails to shape an optimal price system, while markets would themselves assimilate successfully the social cost of any activity. Ronald Coase and Harold Demsetz question State action even in fields where the market mechanism does not seem operational, such as merit goods or natural monopolies (lighthouses). They believe that private initiative and competition better perform these activities.[28]

In general, those schools considerably restrict the role of the State. The latter shall only ensure public order, competitive markets and income redistribution by moderate taxation. Any further action, even in the name of justice or solidarity, risks to be inefficient and non-productive.[29] An even more aggressive approach, adopted by 'anarcho-capitalist' libertarians, seems to totally reject the need for non-consensual institutions, having full confidence in private initiative and co-operation.[30]

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22 A collection of Posner's essays on public law by *Parisi* 2001.
23 *Posner* 1987b.
24 *Kitch* 1983.
25 *Posner* 2014.297,759; *Posner* 1997a.
26 For a full, retrospective view of the Austrian School, *Rizzo* 2011; *Rajagopalan/Rizzo* 2017.
27 *Coase* 1988.
28 *Demsetz* 1968, 1970; *Coase* 1974; *Posner* 1969.
29 *Kaplow/Shavell* 2000, 2002; *Hayek* 1978, 1978–1981.
30 See the studies collected by *Stringham* 2007.

2.1.2 New institutional economics and Public Choice

New institutional economics[31] uses economic tools – especially the notion of transaction cost[32] and its various aspects (information asymmetry, limited rationality, agency problem, and so on) – to study formal, non-consensual institutions. Through the work of Douglass North, Oliver Williamson and, recently, Daron Acemoglu, they shed light on how those organisations co-exist, interact and should be managed. Public authorities that impact economic performance are a primary subject of research, since their action presents several pathologies (monopolistic position, hierarchical structure). Institutional economics work on the organisational and operational models that could maximise their efficiency.[33]

According to Douglass North, the significance of public institutions for growth, sustainability and welfare exceeds that of indicators used in classical economics (natural resources, technology). To put it simply, a country (or a supranational organisation such as the EU[34]) with 'good' and 'modern' institutions is better placed than another with rich mineral deposits. Institutional change is closely related to public law (constitutional framework, administrative rules, judicial system). However, that change faces many complex obstacles, often arising from social rigidities of an ideological and moral nature (xenophobia, religious beliefs, chauvinism). Those hindrances impact the degree of success of State institutions.[35] Economic growth needs a receptive and neutral legal order that produces stable and optimal rules.[36] The absence of such a legal system and of sufficiently open institutions is a major reason why nations fail.[37]

New institutional economics neighbours another, equally important, stream of economic analysis: Public Choice theory.[38] This school is extremely val-

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[31] See the contributions in *Ménard/Shirley* 2018 and the works of *Eggertsson* 1990; *Furubotn/Richter* 2005; *Komesar* 1994; *North* 1981; *Riker* 1990; *Riker/Ordeshook* 1973; *Riker et al.* 2004; *Shaffer* 2013; *Stearns* 2000, 2010; *Brousseau/Glachant* 2008; *Coase* 1998.

[32] *Williamson* 1975, 1981, 1999.

[33] *Williamson* 1985; *Miller et al.* 2018.

[34] For institutional approaches on EU integration, *Kolmar* 2003; *Pierson* 1996; *Dawson et al.* 2015; *Marelli/Signiorelli* 2016; *Gerapetritis* 2019.

[35] *North* 1990, 2010.

[36] *Hadfield* 2008; *Mercuro* 2016.

[37] *Acemoglu/Robinson* 2012. See Chapter 1, section 2.1.2. On the influence of cultural issues on economic growth see the articles collected by *Spolaore* 2014.

[38] *Buchanan/Tollison* 1984; *Tullock* 2008; *Rowley* 1994; *Napolitano/Abrescia* 2009.31; *Croley* 2010; *Farber/Frickey* 1991; *Farber* 2017; *Farber/O'Connell* 2010; *Ginsburg* 2010a; *Gunningham* 1992; *Mashaw* 1989; *Mueller* 2003; *Stearns* 1997; *Van Den Hauwe* 2000. For a more recent, overall view *Congleton et al.* 2019a, 2019b.

uable for public law scholars because it focuses on political and regulatory mechanisms for exercising public authority. Public Choice was first developed at Virginia Law School by James Buchanan and Gordon Tullock with their book *The Calculus of Consent*, published at around the same time as the Coase theorem.[39] It uses microeconomic tools to criticise political institutions 'without romance'.[40] It involves a rather pessimistic reading of democracy and its institutions by describing them as markets that are vulnerable to serious opportunistic behaviours.[41]

Public Choice theory (in its initial version, as it started in the 1960s) removed the halo from representative democracy and revealed – in the definition given by Mancur Olson – the 'logic' of collective action.[42] According to this school, the operation of public bodies depends on human relations and self-serving strategic behaviours, to be examined in the light of economic theories (rational choice, game theory). The action of State institutions (parliament, government, local authorities) is shaped in a framework of competitive, complex transactions: a) competition between candidates, b) competition between pressure groups – which, as Gary Becker notes,[43] advance their own agendas; c) transactions between voters, representatives and lobby agents. These transactions determine how and in whose favour the Demos produces and transfers public goods.[44] They also designate those who will pay for public goods in the form of tax obligations. This powerplay is exposed to the players' opportunistic tendencies; it does not necessarily lead to rational, objective and consistent public choices, in the service of the general interest.[45]

Public Choice uses the same economic methodology to examine administrative bureaucracy.[46] It perceives administrative authorities as institutions in which individuals, despite being assignees of the general interest and having the duty to comply with the principle of legality, choose rationally to advance their own objectives. Their behaviour creates considerable principal-agent costs in public policies.

The Chicago School questioned the omnipresence of market failures and the self-evident necessity of public intervention. Public Choice went a step further:

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[39] *Buchanan/Tullock* 1962; *Tollison* 2009.

[40] According to an expression used by *Buchanan* himself (1984a).

[41] *Downs* 1957.

[42] *Olson* 2002.

[43] *Becker* 1983. On Gary Becker's contribution to law and economics, *Posner* 1993a.

[44] *Lewinsohn-Zamir* 1998.

[45] Collective decisions face the problems arising from Arrow's paradox: see Chapter 2, section 3.3.3.

[46] *Niskanen* 1971, 1994.

it pinpointed State failures when intervening to correct the imperfections of free transactions. In the same context, George Stigler presented his theory of *regulatory capture* in 1971:[47] administrative bodies that regulate an economic activity might operate in the service of specific pressure groups instead of promoting the general interest. By doing so, they do not guarantee but rather manipulate the social surplus of that regulated activity. They convert a part of the surplus into a *'rent'* for those behind the capture.[48]

2.2 Towards a Less Phobic Economic Approach to Public Law

The above theories are not always immune to methodological and ideological obsessions.[49] Despite the critics, their contribution has been extremely valuable for public law. They overturned an idealised perception of public law and revealed many of its shortcomings. They also developed a method for positive analysis of universal value that was later used for perceptions more favourable to public action. These new approaches – whether one considers them offshoots of law and economics, of new institutional economics or of public choice (which in any case overlap) or as autonomous academic streams – have enriched the economic analysis of public law even further.

2.2.1 Yale Law School and progressive economic analysis

Yale Law School was among the first to propose a friendlier economic approach to public law. Guido Calabresi, one of the fathers of economic analysis of law alongside Coase and Posner, gradually switched his interests from tort law[50] to public policies and merit goods.[51] He explained why markets commit 'tragic choices' when called upon to supply some of the most crucial needs: free transactions do not fully satisfy the social demand for merit goods.[52] For example, dialysis treatment is a 'life and death' service for those suffering from kidney failure. However, private providers offer it only to those who can pay its (high) cost. This situation is 'tragic' for two reasons. First, because the allocation of this medical service through the market is contrary to the ethical values of a liberal society (especially to the right to life). Second, because such

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47 *Stigler* 1971.

48 *Olson* 2002 (1965); *Krueger* 1974; *Rowley et al.* 1988; *Tollison/Congleton* 1995; *Congleton/Hillman* 2015.

49 A critique made by Duncan Kennedy and the Critical Legal Studies school (*Kennedy* 1997).

50 *Calabresi* 1970; *Calabresi/Melamed* 1972.

51 *Calabresi*'s impact on economic analysis of law in *Marciano/Ramello* 2019; *Gordon et al.* 2019 and *Hylton* 2009.

52 *Calabresi/Bobbitt* 1978.

an allocation leads to a lose/lose situation, for both the patients and the society; denying the dialysis treatment to a new scientist (who could be Albert Einstein or Stephen Hawking) deprives them of the gift of life, and the whole world of the benefit of their scientific discoveries. For Calabresi, market imperfections exceed the narrow transaction costs described by Coase. They set a false price on 'priceless' goods and distribute them inefficiently. The State has to assume a corrective role, which cannot be exhausted in imitating the market.[53]

Such a curative public action requires an administrative law that is appropriate for that purpose; economic theory may help to shape it. 'Progressive economic analysis' – a term accredited to Susan Rose-Ackerman,[54] professor at the same university – is crucial in re-designing public authorities and in re-defining the general interest.[55] The Demos shall perform successful public policies that combine efficiency objectives and solidarity where and when markets fail. To do so, it needs an administrative law that renders public structures more effective by correcting their shortcomings, such as corruption.[56] In the same line of thought, Jerry Mashaw[57] perceives public intervention as a response to the 'greed and chaos' caused by unrestrained individualism. He refers to economic analysis in search of a more functional model for taking and implementing public decisions. Mashaw advances a creative reading of public choice theories, with a view not to deconstruct the State but to create a better public law. To him, measuring efficiency is a means of improving democracy and rights protection.

2.2.2 The study of the 'regulatory/administrative State' and its tax policy

Such a better public law leads to modern State policies that promote transactions together with other social welfare requirements. It relies on transparency, open procedures and cost–benefit analysis. It evolves under the influence of *economic theories on regulation* that have been developed over the past 50 years. Those theories are a key element of the economic analysis of public law.[58] Following them, public intervention shall focus on (some argue it must

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[53] *Calabresi* 1991 (2014).

[54] *Rose-Ackerman* 1988, 1986, 1996, 2007.

[55] 'A newer version of public interest theory leaves the old dogma and introduces some empirical content to the argument. This "progresses" public interest notion somewhat': *Rose-Ackerman* 1988.

[56] *Rose-Ackerman* 1978.

[57] *Mashaw* 1997, 2010a.

[58] *Baldwin et al.* 2010; *Posner* 2000, 2014b.329; *Adler* 2000; *Dellis* 2010; *Bagley/Revesz* 2006; *Bamberger* 2006; *Bressman et al.* 2010; *Breyer* 1982, 1995; *Crocker/Masten* 1996; *Farina* 1989; *Feintuck* 2004; *Fisher* 2007; *Graham* 2010; *Hahn* 2004; *Hantke-Domas* 2003; *Kahn* 1988, 1992; *Littlechild* 2008; *Ogus* 1994, 2001,

be confined to) correcting the operation of the markets when required, via appropriate tools of economic and social regulation. Economic regulation aims mainly at establishing free competition, while social regulation guarantees other aspects of the general interest (food safety, protection of workers, confidentiality of communications, TV advertisement standards).

The projection of economic theories onto regulation to public law gave birth to a new model for organising the Demos: the *'regulatory/administrative State'*.[59] Initially developed in the US, it has gradually transferred to Europe via EU rules. This model entrusts a vast number of public choices to independent administrative entities with technocratic expertise, rather than to political bodies. It aims to reduce the defects of representative democracy but creates new ones, such as regulatory capture. Moreover, it incorporates economic methods into the administrative and legislative process to enhance the efficiency of public decisions. Through public regulation, economic analysis can be paired with administrative law in numerous areas, from preventing accidents, to public health,[60] a clean environment[61] and data protection.[62] In those sectors as well, procedures and instruments inspired by economic theory increase the efficiency of the regulator. Studying the 'administrative/regulatory State' is a recent trend in public law and comparative research.[63] Many scholars have dedicated their research to this new field. Among them is Cass Sunstein, professor at Chicago and Harvard.[64] He has worked on various topics, including cost–benefit analysis,[65] government regulation in the fields of health and environment,[66] the significance of fiscal interventionism in safeguarding rights[67] and re-designing State intervention through behavioural economics to forge a more 'libertarian' paternalism (along with Nobel Laureate Richard

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2004a; *Oliver et al.* 2010; *Peltzman* 1976; *Pildes/Sunstein* 1995; *Prosser* 1997, 1999; *Rose-Ackerman* 1992, 1994, 2010; *Scott* 2010; *Stigler* 1971, 1975; *Stiglitz* 1989; *Sunstein* 1995, 1996, 2002a, 2005a, 2011a, 2014; *Sunstein/Pildes* 1995; *Szyszcak* 2007; *Van Den Bergh/Pacces* 2012a, 2012b; *Viscusi et al.* 2005.

[59] *Sunstein* 1993; *Rose-Ackerman* 1992; *Rodriguez/Weingast* 2015; *Yeung* 2010. For a critical view of the EU's regulatory State, *Joerges/Glinski* 2014.

[60] *Arcuri* 2012; *Breyer* 1995; *Livermore/Revesz* 2014.

[61] *Faure/Skogh* 2003; *Faure* 2012; *Revesz* 2015.

[62] EU legislation on data protection (GDPR) is a perfect example of this new regulatory approach. See Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 (OJ L 119, 4.5.2016, pp.1–88). *Voigt/Von Dem Bussche* 2017.

[63] *Rose-Ackerman et al.* 2017; *Rose-Ackerman* 2012; *Ramello* 2016.

[64] *Sunstein* 1993. *Sunstein* also acted as head of the Office of Information and Regulatory Affairs during the Obama administration in the US.

[65] *Sunstein* 2002a.

[66] *Sunstein* 2002b, 2011b.

[67] *Sunstein/Holmes* 2000.

Thaler).[68] Focusing on the modern aspects of regulation (*Régulation* in French, *Regulierung* in German, *Regolazione* in Italian) was also the 'Trojan Horse' that allowed economic analysis to invade, in disguise, the castle of public law in Europe – even its most reluctant legal orders.[69]

Economic methodology is also important to assess the various fiscal policies and measures in place.[70] It helps us to understand the interaction between the various forms of taxes and growth,[71] and to set optimal tax levels for maximising social welfare.[72] The Laffer curve[73] is an economic theorem on how public revenues depend on tax rates. It is so crucial that every law scholar, policymaker and judge should be familiar with it before implementing or interpreting fiscal law provisions. It shows that State revenues increase as tax rates rise from 0 per cent up to a certain level; after that ideal point of the curve,[74] the amount of collected taxes gradually decreases as tax rates rise. Rational economic players lose their incentive to maximise their income if the lion's share is to end up in the State's pockets.[75]

2.2.3 An economic view of political and constitutional institutions: positive political theory; political economy of law

The contribution of economic analysis is equally vital for constitutional and political studies. Constitutional and political economics[76] is a modern scientific field nourished by several academic streams.

Constitutional political economy, founded by Buchanan and Brennan,[77] is one such stream. It places emphasis on State failures and on the need for a constitutional design that reflects a more 'individualist' social contract. According to this view, constitutions should drastically restrict the margins for public intervention and prevent political and administrative authorities from enlarg-

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[68] *Sunstein/Thaler* 2003; *Thaler*/*Sunstein* 2008.

[69] As did *Jean-Bernard Auby* with the workgroups he organised at Sciences-Po (Paris, France) to study regulation and the other *'Mutations de l'Action Publique et du Droit Public'*: *Szyszczak* 2007.

[70] See the collection of articles by *Weisbach* 2008 and by *Auerbach/Smetters* 2017. See also *Shaviro* 2017; *Salanié* 2003; *Kaplow* 2008; *Slemrod* 1991; *Bankman/Weisbach* 2006; *Mankiw et al.* 2009.

[71] For example, between consumption and income taxation: *Warren* 1980; *Bankman/Weisbach* 2006.

[72] *Akerlof* 1978; *Bankman/Griffith* 1987; *Kaplow* 2008.

[73] *Fullerton* 2008.

[74] Which can vary, from 25 per cent to a much higher percentage, since taxpayers' behaviour depends on multiple factors.

[75] Excessive tax rates give also incentives for tax evasion. *Allingham/Sandmo* 1972.

[76] A general overview by *Voigt* 2017. See also *Congleton et al.* 2019b; *Parisi* 2003; *Cooter* 2000; *Cooter/Gilbert* 2019.

[77] *Brennan/Buchanan* 1985; *Buchanan* 1991; *Napolitano/Abrescia* 2009.36.

ing their roles;[78] they should provide, even, for maximum tax rates, leaving no discretion to the legislator to raise them.

Positive political theory[79] is another synthesis of approaches to the political phenomenon. Its aim is to objectively demonstrate how public authorities function as mechanisms for reaching collective decisions and to evaluate their performance through economic tools (game theory and the study of strategic behaviours). These methods explore constitutional issues in ways unknown to classical legal thought. They apply economic models for studying electoral systems, the voting process and the way in which political coalitions are formed.[80] Similarly, game theory offers a better understanding of constitutional checks and balances. For example, Tsembelis uses it together with other economic tools in his study on 'veto players',[81] describing the way in which the number and the nature of such players impacts constitutional dynamics.

Modern public choice and constitutional economics is made of numerous empirical studies on administrative and political institutions[82] that allow us to assess their comparative efficiency. Which electoral system – majoritarian or proportional – offers greater stability? Which political model – parliamentary or presidential – deals better with issues of corruption or regulatory capture?[83] Is there an ideal constitution?[84] To what extent do public institutions serve economic efficiency, distributive justice and democratic legitimacy? Does administrative and judicial procedure ensure the compliance of strategic institutional players, such as independent agencies or the courts, to political decisions?[85] Should we interpret the constitution based on the incentive it creates for rational behaviours?[86] How should the EU constitutional and institutional framework evolve to become more effective?[87]

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78 *Brennan/Buchanan* 1980.

79 It first appeared in the 1970s and has flourished ever since. *Riker/Ordeshook* 1973; *Barry* 1989; *Austen-Smith/Banks* 1998; *Tiller* 2017; *Napolitano/Abrescia* 2009.39; *Rose-Ackerman* 2018.

80 *Riker* 1962.

81 *Tsebelis* 2002.

82 A collection of such topics is found in *Voigt* 2012a and 2019 and *Congleton et al.* 2019b. For the EU, *Mueller* 2005.

83 *Epstein* 2017.

84 *Ginsburg* 2017; *Cooter* 1992.

85 This question is raised by a trio of academics known as *McNollgast*, of the Californian school of Political Economy of Law. *McNollgast* 2007.

86 *Cooter/Gilbert* 2019.

87 Among several, *Schmidtchen/Cooter* 1997; *Stephan* 2007; *Eger/Schäfer* 2012; *Dawson et al.* 2015; *Fabbrini et al.* 2015; *Gerapetritis* 2019; *Hofmann et al.* 2019; *Bignami* 2020; *Garben et al.* 2019; *Barber et al.* 2019.

Despite their significant differences, those studies rely on a similar methodology to examine constitutional and administrative law in the light of economic theory.[88] They insist on empirical findings, impact assessment and institutional design to measure and optimise public institutions – to discover the ideal length and the rigidity of the constitutional text,[89] the optimal form of legislation, how often norms should change, which procedures enhance the effectiveness of public decisions. We will tackle some of those issues in the following chapters.

2.2.4 The need for a 'holistic' economic analysis of public law

All of the above leads to one conclusion. Economic analysis of public law has a past, a present and a future.[90]

But what about a general economic theory on public law? Such scope does not seem fully to exist yet. The explanation probably lies with the first 'prophets' of law and economics' negative predisposition towards the State and non-consensual institutions. Nevertheless, the basic pillars for a 'holistic' economic analysis of public law are now in place. Robert Cooter, with his book *The Strategic Constitution*,[91] attempts a general view of American public law from the standpoint of economic method. Another book, by Giulio Napolitano and Michele Abrescia and entitled *Analisi economica del diritto pubblico* (2009), is even more ambitious. It employs the various streams of economic analysis to examine public law as a whole, offering examples from Italian and EU law. It is not a coincidence that two Italians dared to directly

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[88] *McNollgast* 1987, 1989, 1990, 1999; *Farina* 1998; *Sunstein* 1990; *Coglianese* 2002.

[89] *Tsebelis* 2017.

[90] *Becker/Posner* 2017. *The Economics of Administrative Law* (2007), a book edited by Susan Rose-Ackerman, has collected some of the relevant studies, such as Daniel Farber's *Public Choice and Public Law* (2007). Major editorial projects on economic analysis of law deal with similar topics. The second edition of the 12-volume *Encyclopaedia of Law and Economics* (*Gerrit De Geest* (ed.), Edward Elgar) includes two volumes more related to public law: the seventh volume (2011), entitled *Production of Legal Rules*, edited by *Francesco Parisi*, and the ninth volume (2012), entitled *Regulation and Economics*, edited by *Roger J. Van den Bergh* and *Alessio M. Pacces*. The fourth volume (2010), entitled *Antitrust Law and Economics*, edited by *Keith N. Hylton*, also comes under the broader field of public economic law. More recently (2017), the last of the three volumes of *The Oxford Handbook of Law and Economics*, edited by *Francesco Parisi*, is on *Public Law and Legal Institutions.* The two-volume *Oxford Handbook of Public Choice* (2019), edited by *Roger Congleton, Bernard Grofman* and *Stefan Voigt*, covers a vast variety of topics related to the economic analysis of public law.

[91] *Cooter* 2000. Cooter is also the author, with Thomas Ulen, of one of the most important general treatises on the economic analysis of law (*Cooter/Ulen* 2012).

combine the worlds of economics and public law. Public law is rather too important to ignore in Europe, compared to the US. Therefore, it offers itself to more systematic study under the light of economic analysis. This book tries to develop a similar line of reasoning: to propose a general economic theory on public law by mainly using the European example.