

I. RECAP: Civil Law and Economic Development

- A. To this point, we have found that there are economic rationales for legal systems that (i) give use and exclusion rights to producers and over land, (ii) make those rights tradable rights for persons who produce goods and services, (iii) make promises (contracts) enforceable, by threatening fines or imposing other fees on persons who violate (renege) on their promises (contracts), and (iv) deal with accidents effectively.
- i. Communities that have such systems will tend to be far more prosperous than those that do not.
 - ii. Other minor extensions of these ideas, such as the right to inherit property can also reduce overuse tendencies, and adding the right to sell physical assets can also increase “liquidity” and encourage commercial enterprises (trading companies and manufacturing).
 - iii. I would argue that torts have the smallest effect of these four essential areas of law, but nonetheless it seems clear that for many settings, torts will affect investment and economic growth rates by affecting risks. If done well, risks will be reduced by tort law.
 - iv. The advantages of economic wealth and income imply that these essential strands of law may be regarded as “natural rights,” and will tend to be more or less similar in prosperous societies.
- B. We also have explored how law enforcement can make such laws affect behavior and induce economic development.
- i. We have also shown that the optimal level of crime enforcement is less than perfect.
 - ii. Note that crimes will occasionally pay in such an environment
 - iii. (On the other hand, not everyone is a criminal on every possible criminal dimension because economic opportunity costs and internalized norms vary among individuals.)
 - iv. Once at the “optimal level,” crime cannot be reduced further without paying more for reductions than one saves in reduced damages.

II. Alternatives to civil law systems

- A. Although modern civil law systems have stood the test of time, there are other ways to solve the problems that civil law systems address.
- B. One possible alternative is “private law,” the use of contract to create mechanisms for contract enforcement and court proceedings (arbitration).
- i. For example, contracting and tort disputes can also be addressed through arbitration clauses in contracts. (See, for example, the [American Arbitration Association](#).)
 - Many tort problems can also be addressed through combinations of insurance policies and arbitration.
 - For example, the Coase theorem implies that (in the absence of transactions costs) torts can be solved through (forward looking) contracts.
 - (Although such contracts do not really address the problem of “strangers.”)
 - Law enforcement can be provided (and is often provided) through private security services.
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- C. Another alternative is to use a government's bureaucracy to develop regulations and enforce laws--more or less problem area by problem area.
- "Public law" is the use of a regulatory bureaucracy rather than a court system to develop and enforce rules.
- D. One important difference between court systems and the bureaucracy is that politics often plays a larger role in regulatory decisions than in civil law decisions.
- i. The courts can also be thought of a "bureaucracy" that makes rules.
 - ii. But the courts in most Western countries are substantially insulated from politics, which may make them more likely to be even handed.
 - That is, an independent court system may be more likely to treat members of the minority and majorities in the same manner.
 - iii. An independent court system and modern civil law systems, provides a more or less uniform system of rules that can be relied on for most "ordinary settings" and so (potentially) reduces transactions costs and encourage trade relative to many private solutions (assuming that the court system is more or less efficient).
- E. The purpose of the next section of the course is to analyze the types of rules that tend to emerge from majoritarian politics and to contrast them with those that emerge from a common law system.
- We'll also attempt to determine whether there is an economically efficiency case (social net benefit maximizing case) for using the courts for some kinds of rules and the bureaucracy for others.
 - In most cases, it turns out that the "rules of the game" are actually determined by complex combinations of courts, legislatures, private organizations, and the bureaucracy.
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 - We now turn to what is usually called "public law" or "regulation," which may substitute, complement, or undermine civil law.

III. The Median Voter Model

- A. In most of our game theoretic models, it was in the interest of all players to adopt laws that would control their "wealth reducing" behavior.
- In such cases, one can imagine persons meeting together and making decisions via unanimous agreement.
 - However, as such groups get large, such agreements become more difficult to achieve and an agreement to use some other decision rule, say majority rule might be adopted.
 - In the West, majority rule is used to make all kinds of decisions, friendly decisions among friends, to the choice of representatives, to the choice of laws and regulations, to supreme court decisions concerning constitutional law.
- B. The next two lectures analyze majority rule decision making.
- i. We examine two types of democracies: direct democracy and representative democracy.
 - ii. It turns out that the "median voter model" sheds light on both types of democracies.

iii. For the purposes of this course, what is relevant is the kinds of rules that majorities tend to adopt.

C. The median voter model is based on some very straightforward properties of majority rule.

D. For example, suppose that three individuals: Al, Bob and Charlie are to make a decision about the quality of restaurant to have lunch at using majority rule. We'll assume that restaurant quality increases as the average cost of a meal increases (which, of course, is not always true).

- i. Al prefers to spend \$5.00, Bob wants to spend around \$10.00 and Charlie around \$20.00.
- ii. For convenience assume that, given any two options, each will prefer the lunch that is closest to their preferred expenditure.
- iii. (This "spatial voting" model of voter behavior occurs whenever individual marginal benefit and marginal cost curves are approximately straight lines. [[show this](#)])
- iv. Consider some votes by these three friends on various restaurants:

| <u>Options</u> | <u>Votes Cast</u> | | | <u>Outcome</u> |
|-----------------|-------------------|-------|-------|----------------|
| a. \$10 vs 20\$ | A: 10 | B: 10 | C: 20 | 10 MP 20 |
| b. \$5 vs \$20 | A: 5 | B: 5 | C: 20 | 5 MP 20 |
| c. \$5 vs \$16 | A: 5 | B: 5 | C: 16 | 5 MP 16 |
| d. \$10 vs \$5 | A: 5 | B: 10 | C: 10 | 10 MP 5 |
| e. \$12 vs 10 | A: 10 | B:10 | C: 12 | 10 MP 12 |

- v. Note that Bob always votes in favor of the outcome that wins the election. (The B column and the Outcome column are the same.)
- vi. Note also that exactly the same number of individuals prefer a more expensive dinner as prefer a less expensive dinner than Bob.

- (This is the definition of a median ideal point or "preference.")

- a. Bob is the median voter.

- b. He is the voter with the median ideal point.

- vii. Note that the median voter's ideal point can beat every other possible alternative in pair-wise voting.

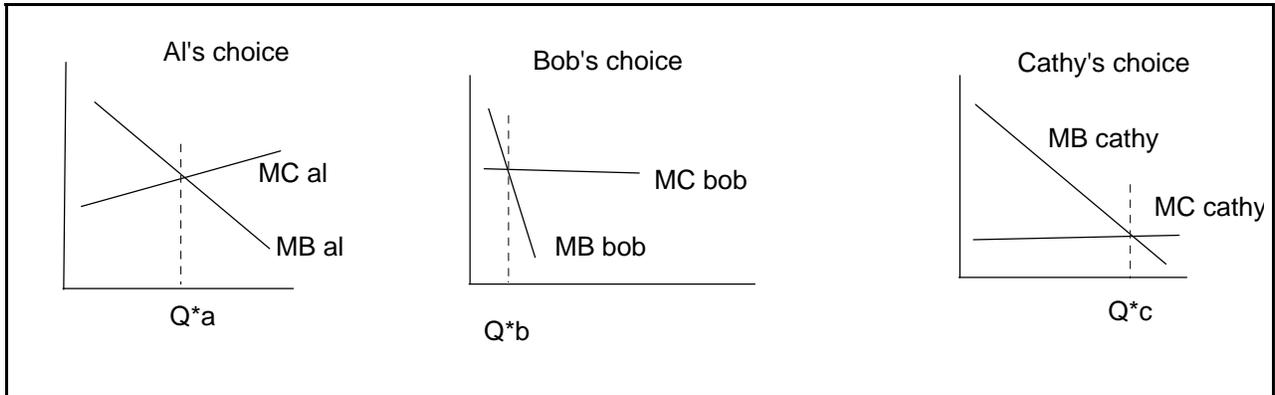
E. The Weak Form of the *median voter theorem* says that the median voter always casts his vote for the policy that is adopted.

F. The Strong Form of the *median voter theorem* say the median voter always gets his most preferred policy. [For example, in the example above Bob's preferred expenditure level, \$10, will defeat any other policy.]

G. An application to Police Enforcement Levels

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- i. We can easily use the above model to think about the amount of money that voters in a community want to spend on police services simply by interpreting the expenditure levels as “qualities” of police and court systems.
 - The strong form of the median voter theorem predicts that the level of police protection selected will be that preferred by the median voter, given his tax costs and his or her expected benefits from reduced crime.
- ii. We can also easily use individual net benefit maximizing choices to characterize each voter’s ideal points, as illustrated below.



- If the horizontal axis is the degree of police protection, and the horizontal scales are all the same, then Al is the median voter and the level of police protection will be Q^*a .
- [\[explain why\]](#)
- Note that the amounts spent on police protection will then be the area under each person’s MC curve from 0 to Q^*a .
- [\[explain why\]](#)

Note also that it is easy to show that each person will prefer policies that are closer their “ideal points” to ones that are further away, because the policy (here level of police protection) closest to a person’s ideal point yields greater net benefits than ones further away.

[\[show this\]](#)

- iii. [A point **for further study**: a median voter on some sorts of policies will not always exist. For example suppose that Al prefers strict liability (SL) to contributory negligence (CN) rules, to negligence rules (N) and Bob prefers N to SL to CN, while Cathy prefers CN to N to SL.
 - In this case, there is no median voter.
 - And the result can be a voting cycle without a stable equilibrium.
 - [Illustrate this by “conducting” votes on N v SL, N v CN and CN v SL. No single outcome dominates each other. Note also that changing the preference order of any one person can generate an equilibrium.]
 - Does the Supreme Court of the US have a median voter? [\[explain why or why not\]](#)
 -

H. Note that if the civil law is determined by economic efficiency in the long run (eg how wealthy a society emerges under its laws) then majority rule outcomes and civil law outcomes may not be the same.

- a. They may not be the same, because the median voter's ideal policy may not be the one that maximizes wealth.
- b. They may not be the same because the distribution of wealth differs under majority rule or civil law.
- c. Court made law and majoritarian law may also differ in the "short run," because civil law may not yet be efficient, and may be improved by the majority (as often argued of civil law reforms).

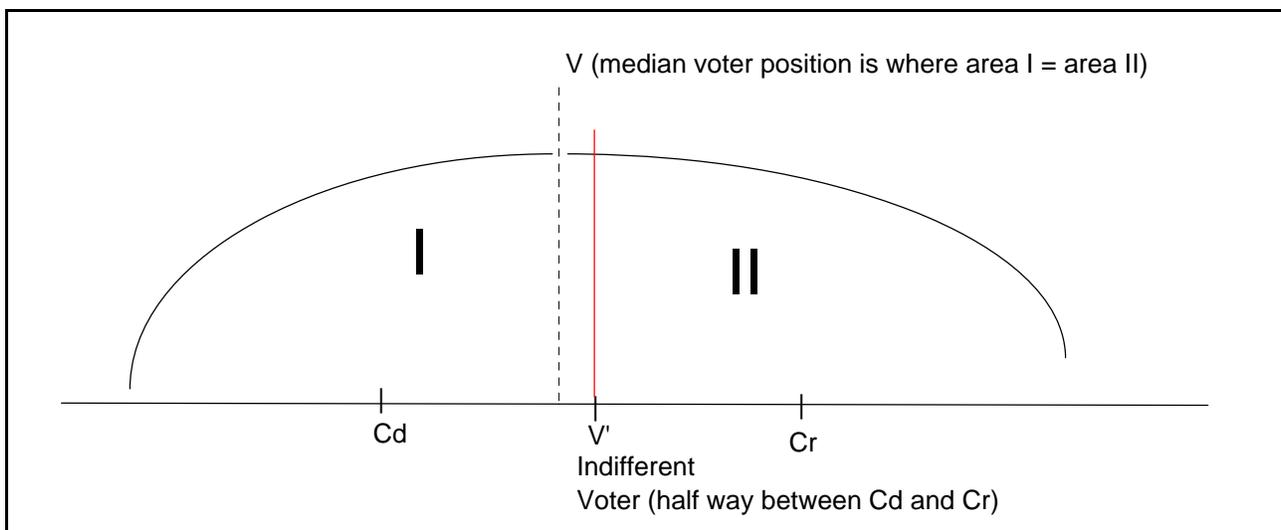
IV. The Median Voter and Representative Democracy

A. The previous examples shows that the median voter determines the outcome in direct democracy systems. We next examine the importance of the median voter in a representative democracy.

B. Competition between candidates for government office can be analyzed with a diagram that shows the distribution of voter ideal points.

- i. That is to say, make a diagram with policy alternatives along the bottom (X) axis and with number of voters along the vertical axis. Plot the number of voters that have each possible "ideal point."
- ii. The area under the resulting curve gives you a number of voters.
- iii. Voters will all vote for the candidate that is "closest" to them in the policy dimension.

C. Illustration of election between two candidates

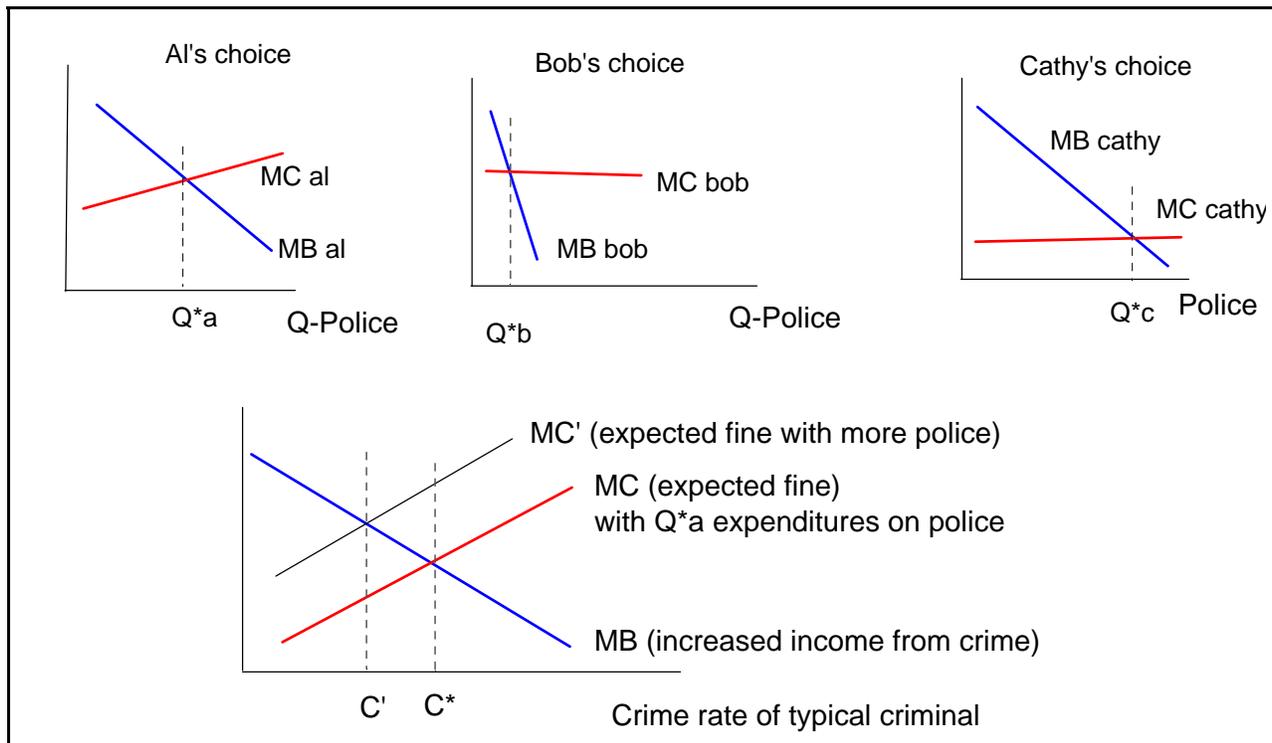


- i. In the figure above, there are two candidates with positions to the left and right of the median voter.
 - The curved line is the "density" function of voter ideal points.

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- The median voter is again the voter in the middle--in the sense that the area under the curve to the right of his/her ideal position equals that to the left of his/her ideal point (area where $I = II$)
 - The voter who is indifferent between the candidate is half way between C_d and C_r .
 - All the voters to the right of the indifferent voter vote for "r" and all the voters to the left vote for candidate "d"
- ii. Note that as drawn, candidate "d" wins.
 - (The area under the curve to the left of V' is greater than that under the curve to the right of V')
 - iii. Candidate "r" can improve his/her vote share by moving toward position V (that of the median voter).
 - iv. If "d" fall behind in the polls because of "r" s adjustments, then "d" can improve his/her position by moving toward V (the median voter's position).
 - v. If this process continues, both candidates will converge to the median voter's ideal point
 - In such cases, the policies of both candidates are essentially the same.
 - And the expected outcome is approximately a tie.
 - (Anyone who believes that this version of the median voter model is realistic, will predict that the next election will be close, e.g. essentially a tie.)
 - vi. This sort of electoral competition implies that the strong version of the median voter theorem also holds in representative democracies.

D. Application: politics and law enforcement: (i) assume voter marginal benefits and marginal costs for spending money on police, (ii) find the median voter's ideal point, (iii) show the median voter's preferred budget affect the level of crime.



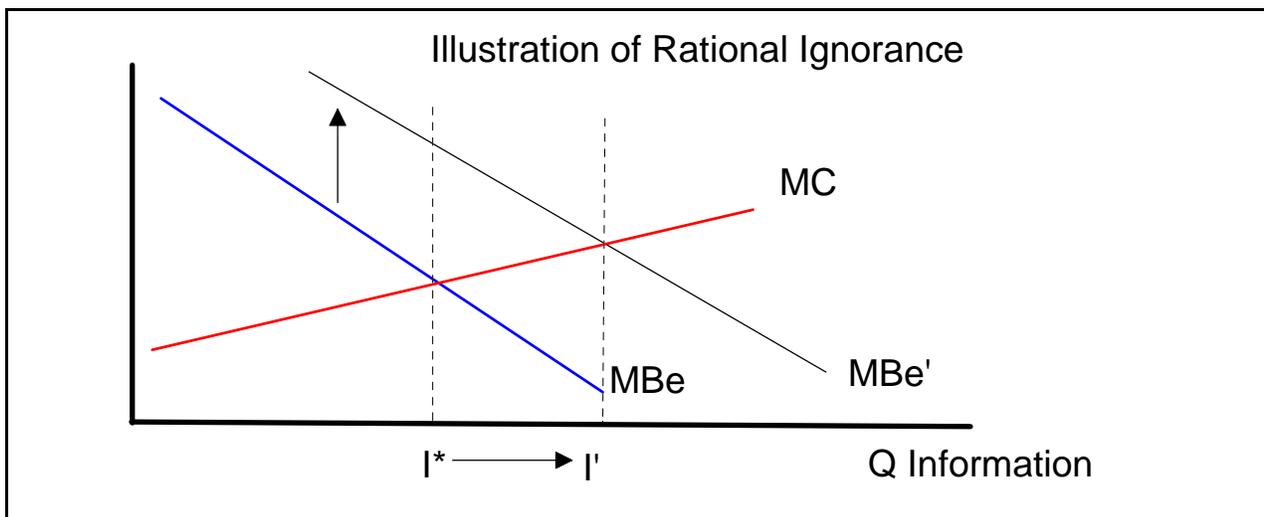
V. Rational Ignorance

A. Rational Ignorance. Unfortunately, voters have only somewhat limited incentives to be fully informed about candidates and their policies.

- a. That is to say, voters will rationally choose to be somewhat “ignorant” of many of the policies and characteristics of candidates running for office.
- b. This implies that voters may make mistakes when they cast votes, by over or under estimating the benefits from public policy.

B. As with any consumer choice, an increase in the **expected** marginal benefits from information will tend to increase the amount of information collected and processed.

- a. The diagram below shows how an increase in the expected benefits from either a policy or from information about a policy will change a voter’s investment in information.
- b. Such shifts can arise, for example, when a person changes his or her job or school and new kinds of information become useful, or becomes older.
 - (Retired folks tend to be better informed about Social Security and Medicare than younger voters.)
 - (Farmers tend to know more about agricultural regulations than ordinary consumers do.)
- c. But only if information is essentially costless would a voter, consumer, or student collect and analyze all available information.



- d. The result may be median voter outcomes that do not actually advance median voter interests and/or opportunities for "back room" politics that favor interest groups rather than voters.

VI. Torts and Regulations as alternative ways of regulating Externalities

A. An alternative to tort law as a means of dealing with externalities, whether damages are intended or not, is economic regulation.

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- Under tort law “accidents” as a class are regulated through liability assignments and general rules (and ideas) enforced through law suits about trespass and reasonable care.
- Under regulatory law specific types of accidents are addressed through rules and punishments that will prevent (stop lights) or ameliorate accidents (seat belts).
- During the 20th century, a broad range of regulations have been adopted to deal with cases that could otherwise have been addressed through tort or contract law.
- (Other laws were not dealt with by common law at all, but may still be of interest to modern voters and firms.)

B. Note that both torts and regulations can “prevent” accidents by inducing persons to exercise proper care.

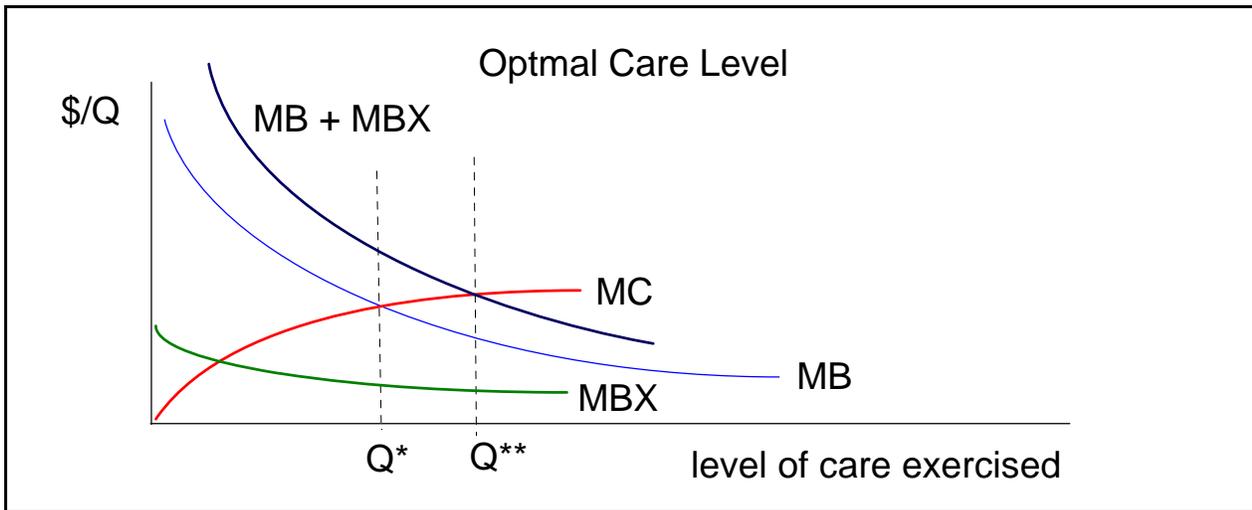
- i. At issue in determining which method is best are issues such as (i) system cost, (ii) effectiveness (damage reduction), and legitimacy (public support).
- ii. Regulations, unlike common law, emerges for the most part from legislation and from the decisions of regulatory agencies.
- iii. Thus to understand the sorts of regulations that tend to be adopted requires an understanding of political decisionmaking.

C. To illustrate this, let us return to the first problem that we analyzed in the Tort Law lectures. Suppose that there are spillover benefits associated with AI’s choice implies that it likely that socially suboptimal levels of care will be adopted.

- In the diagram below Q^{**} is the level of care that an individual should adopt to take account of the damages that his or her accident impose on third parties.
- i. As we saw in the tort section of the course, making AI responsible for damages caused by his accidents is one way to induce AI to take account of spillover damages.
 - That rule in torts is called strict liability.
 - ii. An alternative is simply to mandate care level Q^{**} and back up the law with an appropriate fine.
 - The smallest expected fine that will do so is one that is equal to MBX at Q^{**} --what might be called a Pigovian fine.
 - iii. To see whether we would expect such policies to be adopted, we’ll need to apply a few key models from public choice.
 - a. To do so using election-based models requires imagining (and drawing) the perceived advantages and costs of controlling the externality (accident generating behavior) under study.
 - b. Each voter will have different impressions of both the MB and MC of regulating the externality and so will vote differently on the issue.
 - c. The strong form of the median voter model predicts that the actual regulations adopted will be those that maximize the expected net benefits of the median voter.

D. Regulators are not necessarily interested in maximizing social net benefits. Instead they may be interested in maximizing Congressional support, who in turn are interested in maximizing electoral support.

- i. The extent to which a regulation is tough (stringent) or not, the level of fines to imposed on persons violating the regulation, and the resources used to enforce the regulation can all be



directly (or indirectly) voted on.

- ii. Alternatively, the activities to be regulated may be decided by bureaucrats who are controlled by elected officials who tend to be interested in advancing median (moderate) voter interests.

E. To compare outcomes from tort cases with those from regulatory agencies requires models of law enforcement, trials, and politics.

- i. Regulations, unlike common law, emerges for the most part from legislation and from the decisions of regulatory agencies.
- ii. Tort law tend to emerge (in the US) from court decisions.
- iii. Recall that torts can be considered a method of encouraging persons to take precautions that produce benefits for other persons.
 - There are spillover benefits associated with AI's choice of care level, which implies that it likely that socially suboptimal levels of care will be adopted.
- iv. In the diagram below Q^{**} is the level of care that an individual should adopt to take account of the damages that his or her accident impose on third parties.
- v. As we saw in the tort section of the course, making AI responsible for damages caused by his accidents is one way to induce AI to take account of spillover damages.
 - That rule in torts is called strict liability.
- vi. A regulatory (political) alternative is simply to mandate care level Q^{**} and back up the law with an appropriate fine.
 - The smallest expected fine that will do so is one that is equal to MBX at Q^{**} --what might be called a Pigovian fine.
 - To see whether we would expect such policies to be adopted, we'll need to spend a little time developing a few key models from public choice.
- vii. At issue is whether the median voter will prefer the "SNB maximizing" regulation (Q^{**}) and fine combination.

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- Of course, if courts are less than perfect, then the effective internalization of damages imposed on third parties may also be less than perfect.
- (Juries may return damage awards that are higher or lower than actually generated.)
- This could happen, for example, when one of the parties (say the one with the best lawyers) often can avoid damages (or is able to obtain larger than optimal damage awards).

F. Note that both torts and regulations change incentives and in this way affect the behavior of persons before an accident happens.

- Both torts and regulations “prevent” accidents by inducing persons to exercise proper care or face significant penalties (court liability judgments and/or fines).

G. The associated constitutional or quasi-constitutional question is whether common (civil) law or regulations do this best in a given area of law.

- i. Which method is best involves sorting out issues such as (i) system cost, (ii) effectiveness (damage reduction), and legitimacy (public support).
 - ii. Ultimately, the choice is between two imperfect systems.
 - The most effective system (civil law or regulation) varies with the problems addressed.
 - For example, tort law has no provisions for encouraging activities that generate positive externalities other than those associated with accidents.
 - In some cases, where risks are large, it will be better to have regulations in place before a new market or technology is applied, rather than waiting for courts to work out what is “reasonable” conduct in a new area of torts. (As likely to be the case with fracking.)
 - On the other hand, regulating every possible risk will itself impose externalities on people, because the regulations will be imperfect. In such cases, the general “reasonable conduct” standards of the courts may impose a smaller burden and generate better (higher SNB) results than regulatory solutions.
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VII. How Do Interest Groups Affect Public Policy?

- A.** There are a variety of perfectly legal methods by which interest groups can affect public policy.
- B.** First and probably most important is persuasion. Interest groups may attempt to persuade the public (voters), their representatives, or regulations that the “best” policy just happens to be the policy that generates large profits or transfers to the groups of interest.
- C.** Second, in a democracy or dictatorship, interest groups may provide support for those in power which makes it more likely that those in power continue in power. Such support may be rewarded with favorable public policies
- i. In democracies this can be done with “single issue” voting, public protests/support, and with conditional campaign contributions.
 - ii. In dictatorships, it may be done with gifts, organized public demonstration in support of the ruler(s), and trading favors to those with the power to make policy decisions.
- D.** Third, there are illegal methods of influence: bribery, threats of violence, blackmail, etc. of relevant policy makers.
- E.** [All are used, although not equally in every country.]

VIII. Appendix A: Rent-Seeking Losses from Interest Groups and in Trials

- A. Tullock's extension of the Olsonian approach was to note that all these collective political activities are costly.
- B. Moreover, to the extent that the policies lobbied for are transfers programs, or programs with a positive dead weight loss, it may be said that all the resources used to get those programs adopted are wasted.
- That is to say, these resources are not used to produce new goods and services or efficiently enhancing services, although they could have been used for such productive purposes.
 - Instead these rent-seeking resources are consumed in conflict over the existing "social pie."
 - (To an economist, a "rent" is compensation above one's opportunity cost. Many rules that prevent competition in one way or another may be said to generate rents or profits for the persons receiving preferential treatment.)
- C. Tullock argued that not only are resources wasted in the pursuit of monopoly privileges and protective tariffs, but that that waste may be very large.
- Indeed, he argues that in a perfectly competitive market, the rate of return on rent-seeking activities should fall to that of other possible uses of a person or firm's resources.
 - That is to say the "rents" from rent seeking will all tend to be consumed by the process of competing for them.
 - [Figure or rent-seeking costs involved in Monopoly or Tariff policy.]
 - [Illustration of the rent-seeking game with a two person 3x3 game matrix.]
 - [Optional: Mathematical illustration of the simple rent seeking game with $R_j^e = R [E_j / (\sum_i E_i)] - E_i$ where R is the prize and E_i is the effort of the i th group or individual.]
- D. Thought questions:
- To what kinds of activities other than politics might the logic of the rent seeking model apply?
 - How might one reduce the extent of rent-seeking losses?
 - How does rent-seeking differ from ordinary auctions?
 - Is the rent-seeking industry as large as you might expect based on Gordon Tullock's argument? Why or why not?
 - In what ways are court proceedings like rent-seeking contests?
 - [Tullock actually developed his second model of rent-seeking after working it out for some of his early work on trials in his *Logic of the Law*.]

IX. Appendix B: Olson's *Logic of Collective Action* (1965)

- A. Although it may be argued that many of the ideas contained in this important book were in the "air" at the time it was written, Olson's book stands out as a very readable, original, and impressive analysis of the problems of organizing collective action.
- B. The book deals with collective action in general, but for the purposes of this part of the course, its implications for politically active groups is most relevant.
- First, note that group efforts to influence policy via coordinated voting, lobbying, campaign contributions, etc. are all public goods for the group's members. When a policy is influenced

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it, all members of the group (say farmers) benefit whether they have contributed to the collective effort or not.

- ii. Overcoming this public good or free rider problem is the most important impediment to collective action.
- iii. [Figure: the private marginal costs and benefits of collective action to an individual.]
- iv. Olson argues that small groups of persons or corporations with relatively intense or large interests in policy *are more able to organize* than large groups whose members have relatively small interests at stake.
- v. Small groups may therefore be able to exploit larger groups.
- vi. That is to say, small politically active groups they may be able to get preferential government policies adopted which benefit themselves at the expense of other larger groups.
- vii. [Note that rational ignorance must play a role in such policies in a democracy. Why?]
- viii. Moreover, the benefits received by the small group may be less than the cost imposed on the large unorganized or poorly organized group.

C. In addition to group size and the intensity of individual member interests, Olson notes that various instruments can be used to help overcome the organizational problems of large and small groups.

- i. For example, most politically active groups may provide benefits of some kind that are directly related to membership. That is to say, if it is possible to exclude non-members from at least some of the group's beneficial activities, there will be stronger incentives to join, and weaker incentives free ride.
- ii. Olson calls such devices: selective incentives.
- iii. Thus farm coops provide many services to farmers in addition to lobbying for preferential farm policies. Environmental and senior citizen groups often sponsor trips, newsletters, and so forth.

D. Thought questions:

- i. Name several groups that appear to be effective at influencing public policy.
- ii. What methods do they seem to use?
- iii. Does the general flow of direct and indirect transfers look like Olson's analysis suggests?
- iv. What is the optimal size of an interest group?
- v. Is free-riding necessarily a social problem in this case from the point of view of the Pareto criteria?