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VERY PRELIMINARY VERSION

State Liability[°]

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Extended Abstract

The idea that external effects are a source of social loss and should therefore be internalized is one of the most, not to say the most, common theme in the economic analysis of law, which is mainly concerned with the identification of efficient legal rules to achieve this goal. The Coasean tradition has better qualified this endeavor by distinguishing between those situations that are characterized by low transaction costs, in which internalization of external effects occurs through voluntary agreements, and those in which transaction costs are high and where some legal intervention may be necessary. In the latter case, Gary Becker and Guido Calabresi have laid the foundations for the analysis of the two most widespread, historically and currently, legal devices employed to internalize externalities, namely, criminal law and tort law.

These two bodies of law are mainly concerned with providing incentives for individuals and firms not to impose harm on others. From here, the step towards advocating tort liability for public organizations such as states, regulatory agencies, local government branches, the police, or the judiciary is relatively short. In this paper, we examine the incentive effects of state liability and show that they can be classified in two main categories: the *production of incentives* for the state to act properly versus the *removal of incentives* for private parties when these incentives are distorted. To illustrate, state liability for failure to maintain the roads pertains to the former category. Here the traditional internalization argument goes as follows: If the state is liable for failure to maintain

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public roads, the prospect of paying damages will make state employees choose the optimal level of maintenance expenditures in just the same way as a firm's vicarious liability makes its employees internalize the harm to victims and thus choose the adequate levels of care in undertaking potentially harmful activities. In this case, state liability is supposed to produce good incentives for the state organs, bodies and officials. The second category includes situations such as those in which a corrupt official refuses to issue a permit to an honest entrepreneur unless he is paid a bribe. In this case, the idea is not that state liability will produce incentives but rather that letting the victim of the abuse rely on damage compensation paid by the state makes it less likely that he or she will feel inclined or compelled to bribe the public official. In this case, liability is supposed to remove incentives for private parties to engage in activities that corrupt state officials.

The former aim (producing incentives) is vulnerable to a fundamental failure in the chain of command. That is, making the public organization liable may fail to provide its employees with incentives to act efficiently, for the sanction imposed on the organization might not reach the responsible individuals. Absent other incentives for individual officials, liability will not improve the actions taken by the public organization.

Although it has been only occasionally mentioned in studies concerning state liability, the question whether incentives are transferred from the organization to its agents is not novel in economics. An analogous issue arises when firms are vicariously liable for misconduct of their agents and is a manifestation of the well-known agency problem between organization and their subordinates. Public administrations have fairly inflexible regimes of salaries and internal promotions (seniority prevails in most systems as the major factor for promotion) that do not allow free renegotiation or readjustment in case of state liability. Although public administrators normally lose their jobs following a criminal conviction for particular crimes, and this system could be extended to tort judgments based on a finding of negligent behavior, the problem remains in areas of strict tort liability, where a finding of negligence on the part of the administration is not necessary for the establishment of the agency's liability and hence the dismissal of the (potentially nonnegligent) responsible official would legally unsound and economically inefficient in most cases. Moreover, even a reduction in the nominal salary as a consequence of causing an accident or misbehavior is usually not allowed. Because of such obstacles to the channeling of responsibility through the employment contract, criminal law remains the main source of incentives for state officials; corruption being the most obvious example. However, criminal sanctions require lengthy and fairly expensive proceedings and are likely to target only major violations thus resulting in under-deterrence of misbehavior by state officials.

Another serious problem posed by state liability is how the organizations can structure themselves in order to avoid liability. There are three important aspects. First, the development of departments within the state organization to cover-up misbehavior or negligent behavior by state officials or even accidents if strict liability is imposed. Second, the building of a group of extremely expensive internal and external state legal councilors to argue the case for the state (here with potential conflicts of interest with state prosecutors that might represent the victims). Third, serious adverse selection with respect to hiring personnel and moral hazard across state departments depending on different degrees of exposure to state liability.

The argument that public officials may be shielded from incentives, making state liability ineffective, is not novel and, as we argue, it is not the whole story. We show, in fact, that the

problem may be more serious than that. Imposing liability on the state may not simply fail to improve incentives; it may even dilute them. If the aim is the reduction of accidents, the traditional skeptic would go so far as to say that state liability will, in the worst case, leave the number of accidents unvaried. We argue instead that accidents may increase, because, while failing to improve the incentives of the state officials and employees, state liability may well weaken the incentives of private parties, who can now rely on state compensation of their losses. State liability ends up functioning as a taxpayer-funded accident insurance, which will obviously create a substantial moral hazard problem on the part of those who can benefit from this implicit coverage. We show that a contributory negligence defense better counters these problems than other liability arrangements.

If the production-of-incentive issue is affected by the chain-of-command problem, the removal-of-incentives function is vulnerable to the traditional insurance argument, so often used against tort liability as a way to compensate for losses. The need to remove the victim's incentives is in fact akin to the need to compensate his or her losses. In the example presented above on permit issuance, the permit seeker becomes a corrupting party because he or she is in fact compelled to pay the corrupt official a bribe for fear to be unjustly denied a permit. If the victim can rely on the fact that, should the permit in fact be denied, a legal action against the public administration will result in the payment of damages that will, at least in principle, make him whole, his or her incentives to bribe will be diluted and hence corruption reduced. Note that the reduction of corruption operated by state liability does not follow from the fact that the corrupted official is punished—which is typically desirable, but is not crucial for the sake of our argument—but simply from the fact that the loss deriving from the corrupted official's behavior is compensated *ex post*. Therefore, as long as the victim is not the ultimate bearer of such loss, it is immaterial whether compensation is paid by the state, a compensation fund, or a third party. Using insights from the economic analysis of tort liability, we will argue that the choice of the compensation system should not be driven by notions of responsibility for the loss, but rather by economies in compensation, that is, compensation should be paid in the way that minimizes the administrative burden of the system. Using the liability system for compensation purposes has long been criticized as too expensive a way to achieve a goal that can alternatively and more cheaply be attained by a privately- or publicly-funded insurance system.

After assessing under which conditions state liability should be developed, we must address another important aspect. Any state liability regime presupposes the state as a defendant. Given the specificities of the state as a defendant, it has been argued that a special legal framework, namely specialized courts and judges, specific or distinct procedural rules and a different regime for out-of-court settlements, should govern the liability of the state. Although the general reasoning behind our analysis relates to administrative law in the broad sense, our discussion focuses on the specific question of recognizing a special or different status to the state as a defendant. We cannot separate the state-defendant in tort from other state functions and roles, and hence it is possible that a special legal framework makes sense in some jurisdictions where certain conditions are met (for example, under French law) but not in other jurisdictions (for example, common law).