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COASE AND THE CONSTITUTION: A NEW APPROACH TO FEDERALISM

*F.E. Guerra-Pujol**

This paper proposes a new approach to the centuries-old question of federalism. In a word, we approach the problem of federalism from a Coasian or property-rights perspective. That is, instead of attempting to draw an arbitrary boundary line between state and federal spheres of power through traditional legal or semantic analysis of the constitution and previous judicial precedents, this paper proposes the creation of alternative “federalism markets” in which governmental powers and functions would be allocated to Congress, the states, or even private firms through decentralized auction mechanisms and secondary markets. The paper is divided into five parts. Following a brief introduction, part two models existing federal-state disputes as a game of chicken and provides a brief theoretical outline of our alternative approach. Next, part three develops a simple two-part model of federalism markets, specifically, the use of auctions as well as secondary markets for the allocation of state-federal powers. Part four reviews and refutes some salient technical and philosophical objections to our proposed system of federalism markets, while part five concludes.

I. INTRODUCTION

It is important to begin by noting that the problem of federalism is not peculiar to the United States but rather plagues all federal systems and confederations, such as the United Kingdom, Germany, the European Union. On the one hand, a central authority that is powerful enough to settle disputes between member states and solve collective action problems

* Associate Professor, Barry University, Dwayne O. Andreas School of Law This paper is meant to be more of a thought-experiment than a detailed policy proposal at this early stage, a thought-experiment based on the author's many years of research on property rights and the Coase theorem.. Lastly, the author wishes to thank Dean Leticia Diaz for her moral and financial support as well as Christopher Bailey, Dan O’Gorman, Orlando I. Martinez-Garcia, H. Trent Moore, and Judge Richard A. Posner for their helpful comments on previous drafts of this paper.

is no doubt desirable, but on the other hand, the member states should also be powerful enough to solve purely local problems as well as check potential abuses of power by the central authority.¹ In a word, the problem of federalism can be stated as follows: what is the proper allocation of powers between the central authority and the member states?

This paper proposes a new approach to the centuries-old question of federalism, suggesting an approach to the problem of federalism from a Coasian or property-rights perspective.² That is, instead of attempting to draw an arbitrary boundary line between state and federal spheres of power through traditional legal or semantic analysis of the Constitution and previous judicial precedents, this paper proposes the creation of alternative “federalism markets” in which governmental powers and functions would be allocated to Congress, the states, or even private firms through decentralized auction mechanisms and secondary markets. The remainder of this paper, then, is divided into five parts. Following this brief introduction, part two models existing federal-state disputes as a game of chicken and provides a brief theoretical outline of this alternative approach to the problem of federalism. Next, part three develops a simple two-part model of federalism markets; specifically, the use of auctions as well as secondary markets for the allocation of state-federal powers. Part four reviews and refutes some salient technical and philosophical objections to the proposed system of federalism markets, while part five concludes.

II. THEORETICAL BACKGROUND

In the American context, the problem of federalism is by no means a new one. Ever since Alexander Hamilton’s and Thomas Jefferson’s historic debate over the incorporation of a national bank,³ this question has posed a conflict: what is the proper state-federal balance of power? The breadth of Federal Power has increased over two centuries, from Chief Justice John Marshall’s expansive interpretation of the Necessary and Proper Clause⁴ in the landmark case of *McCulloch v. Maryland*⁵ to the enormous extension of federal powers following President

1. See, e.g., Arthur N. Halcombe, *The Coercion of States in a Federal System*, in *FEDERALISM: MATURE AND EMERGENT* 135 (W. MacMahon, ed., 1955); see also *THE FEDERALIST* No. 51 (James Madison).

2. R.H. Coase, *The Problem of Social Cost*, 3 *J. L. & ECON.* 1 (1960); Harold Demsetz, *Toward a Theory of Property Rights*, 62 *AM. ECON. REV.* 347–59 (1967).

3. See, e.g., KATHLEEN M. SULLIVAN & GERALD GUNTHER, *CONSTITUTIONAL LAW* 71–76 (16th ed. 2006).

4. U.S. CONST. art. I, § 8.

5. 17 U.S. 316 (1819).

Franklin Roosevelt's sweeping New Deal programs.⁶ However, both the law and politics of federalism are as unsettled and contentious as ever.⁷ Simply put, despite the gradual enlargement of federal power since the founding of the American Republic, or perhaps because of it, this vigorous centuries-old legal and academic debate over the proper allocation of state-federal authority refuses to fade away.

The traditional approach to the problem of federalism often involves federal litigation, with the U.S. Supreme Court serving as the arbiter of federal-state conflicts of interest.⁸ This paper refers to these judicial contests as a "federalism game." In this view, federal-state conflicts of interest—the federalism game—can be modeled as a one-shot, simultaneous-move game of chicken in which there are two players (Player A and Player B) driving race cars towards each other at high speeds on a narrow, one-lane road.⁹ The strategy set of the drivers consists of two choices: Swerve (S) or Drive Straight (DS).

In summary, this game produces four possible interactions and payoff combinations:

- (1) S-S. If both players swerve, both drivers obtain a zero (0) payoff, although both avoid being the sole "chicken," there is no clear winner either.
- (2) DS-DS. If both players decide to drive straight, they will collide, imposing an enormous cost ($-2c$) on both drivers. Essentially, both players lose.
- (3) DS-S. If driver A drives straight, while driver B swerves, then A wins and B loses. That is, A obtains a positive payoff (b) for demonstrating his resolute courage and bravery in the face of danger. The other driver, however, by swerving, is the "chicken" and is assigned a negative payoff ($-c$).
- (4) S-DS. Lastly, if A swerves and B drives straight, then A is the chicken, while B is the victor, and the payoffs are thus reversed.

Before proceeding, notice that the respective benefits and costs corresponding with each strategy are represented in abstract terms (the parameters b and c) rather than expressing them in terms of numerical values (such as 1, 2, and 3) in order to illustrate the underlying logic and structure of seemingly unrelated problems. In addition, another advantage

6. See, e.g., Alan Brinkley, *The New Deal Experiments*, in *THE ACHIEVEMENT OF AMERICAN LIBERALISM* 8–16 (William H. Chafe ed., 2003).

7. See, e.g., Kurt T. Lash, *The Original Meaning of an Omission: The Tenth Amendment, Popular Sovereignty, and Expressly Delegated Powers*, 83 *NOTRE DAME L. REV.* 1889 (2008); Robert G. Natelson, *The Enumerated Powers of States*, 3 *NEV. L. J.* 469 (2003).

8. For a small sample of recent federalism cases - all decided by the narrowest of 5-4 margins, see *United States v. Morrison*, 529 U.S. 598 (2000); *U.S. Term Limits, Inc. v. Thornton*, 514 U.S. 779 (1995); *United States v. Lopez*, 514 U.S. 549 (1995).

9. See, e.g., WILLIAM POUNDSTONE, *PRISONER'S DILEMMA* 197–201 (1993).

of expressing these values as abstract parameters is flexibility and generality; that is, the abstract model permits the derivation of results for any value that these parameters might actually take.¹⁰

Given the payoff structure of this game, Drive Straight is the best response to Swerve because b is clearly greater than $-c$. By the same logic, Swerve is the best response to Drive Straight because $-c$ is greater than $-2c$. That is, being the chicken is preferable to being in a head-on collision.¹¹ Therefore, there are two Nash equilibrium in the game.¹²

In many respects, federal-state power struggles resemble a game of chicken because the underlying strategy set—Drive Straight or Swerve in the game of chicken; Litigate or Back Down in the federalism game—and the resulting payoff combinations from these interactions are strikingly similar. Two reasons account for the similarities. First, if both sides in a federalism dispute back down, they avoid the possibility of a head-on collision and thus postpone the resolution of the dispute for another time. Second, if both parties decide to litigate up to the Supreme Court, one will always win and one will always lose, but the identity of the winner cannot be determined at the outset, as arbitrary and unpredictable circumstances will play a large part in the calculus of who will lose his nerve or keep his cool in the very last second. Despite jurisprudence developed over time as the Supreme Court has struggled to interpret the myriad applications of federal structure within the Constitution, the Court has never adhered to a fixed definition.¹³ Even with the assistance of *stare decisis*, court decisions in this area of law tend to be unpredictable and inconsistent, with courts favoring the states in some cases and the federal government in others.¹⁴ Though the Court is a third party not conceived of within the traditional parameters of the game of chicken, forces at work in the ultimate

10. See, e.g., RICHARD MCELREATH & ROBERT BOYD, MATHEMATICAL MODELS OF SOCIAL EVOLUTION 6 (2007).

11. Nevertheless, the game of chicken raises an intriguing though perverse possibility in which the worst possible outcome is to be the sole chicken due to reputation effects. That is, being the chicken might be worse than the cost of a head-on collision if one assigns a higher value to reputation than to safety.

12. AVENDASH DIXIT & SUSAN SKEATH, GAMES OF STRATEGY 87 (2d ed. 2004) (“a Nash Equilibrium in a game is a list of strategies, one for each player, such that no player can get a better payoff by switching to some other strategy that is available to her while all the other players adhere to the strategies specified for them in the list.”).

13. Compare *Gibbons v. Ogden*, 22 U.S. 1 (1824), and *Champion v. Ames*, 188 U.S. 321 (1903), and *Wickard v. Filburn*, 317 U.S. 111 (1942), with *United States v. Lopez*, 514 U.S. 549 (1995), and *United States v. Morrison*, 529 U.S. 598 (2000), and *Jones v. United States*, 529 U.S. 848 (2000).

14. *Id.*

moment of chicken proves an apt analogy to the Court's caprice in this area of the law. This model thus helps to explain why litigation over federalism is a never-ending process. Might there be a better approach to the problem?

Although the problem of federalism has generated a vast and varied academic literature,¹⁵ no scholar has taken a market approach to the problem. In contrast, this paper proposes an alternative approach to federalism, one based on Ronald Coase's original insight regarding the transferability or "tradability" of legal rights.¹⁶ Coase was the first economist to point out that legal rights—such as the right to pollute or the right to clean air—can in principle be traded, so long as those rights are well defined and transaction costs are low.¹⁷ It is this seemingly simple insight—the idea that legal rights, like other goods and services, are factors of production and thus transferable assets—upon which Coase's famous theorem (Coase, 1960) and the whole of "law and economics" are built.¹⁸

This paper extends this insight into the realm of constitutional law: if the right to emit x amount of pollution can be traded in a specialized pollution market, then why cannot the right to operate the post office or enforce antitrust laws be traded in a similarly specialized "federalism market"? Robert Nozick defines legal rights broadly to include the right to regulate behavior and enforce laws: "rights of enforcement are themselves merely *rights*; that is, permissions to do something and obligations on others not to interfere."¹⁹ Accordingly, instead of engaging in traditional constitutional/legal analysis—that is, rather than draw an arbitrary and utterly subjective line demarcating tradable and non-tradable legal rights—this paper proposes a new approach to the problem of federalism, a non-arbitrary mechanism for the allocation of state and federal powers: the creation of multiple "federalism markets." Although this proposed system of federalism markets is more of a thought-experiment at this early stage rather than a fully-worked out policy proposal, the main elements of this approach can be understood as follows:

(a) First, it contemplates the wide range of governmental functions and powers (whether state or federal) through a property-rights framework, or Coasian lens. In this view, the legal right to provide x public good

15. See, e.g., Andreas Follesdal, FEDERALISM, STANFORD ENCYCLOPEDIA OF PHILOSOPHY (2008), available at <http://plato.stanford.edu/archives/fall2008/entries/federalism/>.

16. See R.H. Coase, *The Federal Communications Commission*, 2 J. L. & ECON. 1, 25–26 (1959).

17. See *Id.*

18. See generally RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 23–24 (2007).

19. ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 92 (1974).

or y public service as well as the legal right to regulate the behavior of individuals and firms in a given sector of the economy are valuable property rights. Furthermore, Congress and the states are engaged in a never-ending, constant-sum game²⁰ over these rights, competing with one another for the right to provide public goods, such as lighthouses and national defense, and for the right to regulate certain sectors of the economy, such as aviation and telecommunications.

(b) Due to the intractable “level of generality” or “parallel cases” problem,²¹ constitutional interpretation provides no definitive answer or solution to the question of federalism. Some Supreme Court cases, for example, take an expansive view of Congress’s regulatory powers under the Commerce Clause,²² while other cases take a more narrow view of the same clause.²³ Additionally, the text of the Tenth Amendment provides no more clear or useful guidance than the sparse pronouncements of the Delphic oracle.

(c) Lastly, combining the contradictory judicial precedents and the vagueness or open-textured nature of the constitutional text, with the property-rights or Coasian conception of state and federal governmental powers, this paper proposes the creation of alternative “federalism markets” in which governmental powers and functions would be allocated to Congress or the states through decentralized auction mechanisms and secondary markets. Under this approach, Congress and the states would bid and thus explicitly compete against each other for the right to assume governmental powers or functions.

Before proceeding, it is worth noting that the connection between the Constitution and markets is neither new nor novel. The Takings Clause,²⁴ for example, was explicitly designed to protect private property rights and thus promote voluntary exchange by limiting the government’s power of eminent domain.²⁵ Likewise, one could argue that the Search and Seizure Clause²⁶ promotes markets by protecting both real and personal property—i.e., “persons, houses, papers, and effects”—from unreasonable police

20. See ANATOL RAPAPORT, *GAME THEORY AS A THEORY OF CONFLICT RESOLUTION* 1–2 (1974) (defining “constant sum” games as those “where the sum of the payoffs to the players is the same in each outcome.”).

21. See, e.g., LAURENCE H. TRIBE & MICHAEL C. DORF, *ON READING THE CONSTITUTION* 73–80 (1991); NOZICK, *supra* note 19 at 277–79.

22. See, e.g., *Wickard v. Filburn*, 317 U.S. 111 (1942).

23. See, e.g., *United States v. Lopez*, 514 U.S. 549 (1995).

24. U.S. CONST. amend V.

25. See Bruce L. Benson, *The Evolution of Eminent Domain*, 12 INDEP. REV. 423, 431 (2008). *But see* *Kelo v. City of New London*, 545 U.S. 469 (2005).

26. U.S. CONST. amend IV.

interference.²⁷ In addition, the First Amendment can be seen through a market lens. The Free Speech Clause,²⁸ for example, not only promotes robust political debate but also furthers the free exchange of ideas.²⁹ Similarly, some have argued that the Establishment Clause³⁰ was designed not only to protect religious minorities but also to promote a free and open “religious market” by preventing Congress and the States from favoring one religious sect over another.³¹ Essentially, these constitutional rights protect and promote not only markets in goods and services but also the marketplace of ideas.³² Oliver Wendell Holmes once observed that “men have realized that ... the ultimate good desired is better reached by free trade in ideas—that the best test of truth is the power of the thought to get itself accepted in the competition of the market ... That, at any rate, is the theory of our Constitution.”³³ Within this context, it appears possible to argue that rights to exercise governmental powers can themselves be traded or transferred.

III. FEDERALISM MARKETS

Having modeled state-federal disputes as a game of chicken and explained the theoretical background regarding the transferability or “tradability” of legal rights, including the right to provide public goods and the right to enforce rights, this paper proceeds to outline a simple two-part model of the proposed system of federalism markets. In summary, this model incorporates the use of auctions as well as secondary markets for the allocation of state-federal powers.

A. Auctions

One possible market mechanism for the allocation of federal-state powers is the use of auctions. Since Coase’s proposal regarding the allocation of broadcast rights,³⁴ the use of auctions for the transfer of property rights and other entitlements has become widespread.³⁵ Under this

27. See Akhil Reed Amar, *Fourth Amendment First Principles*, 107 HARV. L. REV. 757, 807–09 (1994).

28. U.S. CONST. amend. I.

29. See generally JOHN STUART MILL, *ON LIBERTY* (London, John W. Parker & Son, 1859).

30. See generally *id.*

31. See, e.g., *THE CONSTITUTION AND RELIGION*, (Robert S. Alley ed., Prometheus 1999).

32. See, e.g., R.H. Coase, *The Market for Goods and the Market for Ideas*, 64 AM. ECON. REV. 384, 384–85 (1974).

33. *Abrams v. United States*, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting).

34. See Coase, *supra* note 16 at 1; see also Leo Herzl, *Public Interest and the Market in Color Television Regulation*, 18 U. CHI. L. REV. 802, 810 n. 54 (1951).

35. See PAUL MILGROM, *PUTTING AUCTION THEORY TO WORK* (2004).

approach, governmental power and functions would be transferred (either individually or in bundles) through an auction mechanism.³⁶ Instead of selling an asset, such as a painting or the rights to a professional sports franchise, the auctioneer would sell governmental power, such as the right to provide a certain public good or service or the right to regulate a given area of the economy.³⁷

This approach is often referred to in economics and game theory literature as “mechanism design.”³⁸ It offers several potential advantages: (1) auctions are an effective and proven method of raising public revenue,³⁹ (2) properly-designed auctions are able to solve asymmetrical information problems through the revelation of private information,⁴⁰ and most important, (3) auctions allow rights to gravitate to those parties who value them the most.⁴¹ However, one must address the problem of how such an auction mechanism would work in practice, who would conduct the auction of public services, and how the states would overcome free-rider⁴² and collective-action problems⁴³ during the auction process?

In general, an all-powerful or centralized auctioneer might not be practical in the context of state-federal competition. After all, it would be impossible to select between the states or the federal government to regulate and oversee the auctioneer: as this question is precisely the problem this paper attempts to solve. Accordingly, instead of a sole, centralized auctioneer, perhaps each administrative or regulatory agency (both at the state and federal levels) could operate as a potential auctioneer of its existing as well as new functions and powers. This proposed system of decentralized of mini-auctions offers “several advantages.

One advantage is logistical: auctions convert an intractable and long-standing political/ constitutional problem into a practical and soluble economic one, for the optimal federal-state balance of power would be decided through markets instead of courts.⁴⁴ That is, rather than rely on a

36. *See id.*

37. *See id.*

38. *See id.*

39. *See, e.g.*, John McMillan, *Selling Spectrum Rights*, 8 J. ECON. PERSPECTIVES 145, 159–60 (1994).

40. *See, e.g.*, Allan Gibbard, *Manipulation of Voting Schemes*, 41 ECONOMETRICA 587 (1973); Roger Myerson, *Incentive-Compatibility and the Bargaining Problem*, 47 ECONOMETRICA 61 (1979).

41. *See, e.g.*, Gibbard, *supra* note 40 at 587.

42. *See* PRINCIPLES OF ENVIRONMENTAL ECONOMICS 260 (Jan J. Boersema & Lucas Reijnders eds., 2009) (defining the “free-rider problem” as one in which actors who choose sub-optimal behavior benefit from the sacrifices if actors who choose optimal behavior).

43. *See* KEITH M. DOWDING, POWER 31 (1996) (defining “collective action problems” as ones in which a group of individuals “find it difficult to coordinate their actions to secure their group interest”).

44. *See id.*

government agency's self-serving assessments of whether it has the political or constitutional authority to provide a certain public good or public service (or whether it has the authority to regulate a given area of the economy), and rather than trusting the federal courts to make this important policy choice, each administrative agency would instead have to compete with other governmental agencies as well as private firms for the right to provide such a public good or service.

Another significant advantage of auctions in place of litigation is that this proposed system of mini-auctions would allow for trial-and-error experimentation and is thus broadly consistent with the underlying spirit of the Constitution and the principle of federalism.⁴⁵ In essence, by allowing each administrative agency at both the state and federal levels to conduct its own series of mini-auctions, each agency could experiment with a wide variety of auction procedures. Although each agency would have an incentive to adopt fair and efficient procedures to maximize its auction revenues, this decentralized approach would also produce a multiplicity of "federalism markets" through a wide variety of localized auction mechanisms.

Lastly and most importantly, the resulting competition in these federalism markets, or markets for governmental powers, would (in theory, at least) maximize gross social benefits, minus the cost of providing public goods and services, because such governmental powers would be allowed to gravitate into the hands of bidders who value them the most.⁴⁶ For example, if a certain federal agency enjoys a comparative or absolute advantage (as the case may be) in a certain area or subject matter, it would be able to outbid state agencies for the right to regulate that subject matter. Or in the alternative, if the efficient result were no regulation (neither state nor federal), then private firms could outbid both the states and the federal government to limit governmental power altogether.

B. Secondary markets

Another market-based approach to federal-state relations involves the creation and legalization of secondary federalism markets. That is, in addition to decentralized auctions, state and federal agencies could trade or sell their existing powers and functions to other agencies as well as private firms. The specific rules and regulations that would apply to these

45. See, e.g., THE FEDERALIST No. 45 (James Madison).

46. See, e.g., McMillan, *supra* note 39.

secondary markets would vary, of course, depending on the type of governmental power or function to be traded, but overall, these secondary federalism markets would share the following five fundamental features:

First, state and federal governmental agencies would not be required to auction their existing powers or functions, thus neutralizing any objections based on the endowment effect or divestiture aversion.⁴⁷ All new powers and functions, however, would be allocated through decentralized auction mechanisms.

Second, once such powers are allocated with auctions, the rights to those powers as well as the rights to their existing powers would be transferable or alienable through secondary markets. That is, each agency would now be free to sell or transfer its powers to willing buyers, and similarly, willing buyers would be able to purchase or buy out governmental powers from willing rights-holders.

Third, the price of such market transfers would be set by these secondary constitutional markets themselves, that is, by both the supply and demand of governmental powers. Accordingly, such prices would (again, in theory) reflect their true social costs.

Fourth, these market transactions would be governed in the main by the common law of torts, contracts, and property (i.e., state law), perhaps with the possibility of review in the US Supreme Court.

Fifth, to promote vigorous competition in such secondary markets, there would be few, if any, formal barriers to entry.⁴⁸ Thus, willing buyers and sellers might include state and federal governmental entities, business firms, and even private charities as well as non-governmental organizations (NGOs).

In general, such secondary-markets, like this proposed system of mini-auctions, offer three fundamental advantages over the traditional, legal approach to the problem of federalism. One major advantage is that such secondary trading will tend to promote the efficient specialization of the factors of production through Ricardian comparative advantage.⁴⁹ Once one recognizes that the provision of public goods and the enforcement of laws (i.e., the traditional functions and powers of state and federal

47. See, e.g., Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39 (1980); Daniel Kahneman, et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990).

48. See MARC LIEBERMAN & ROBERT E. HALL, INTRODUCTION TO ECONOMICS 496–97 (Jack W. Calhoun et al. eds., 2d ed. 2005).

49. See, e.g., *id.*

governments) are factors of production, the logic of this argument becomes transparent at once: those regulatory functions in which state or local agencies have a comparative advantage (or absolute advantage, as the case may be), due to such factors as geography, subject matter, existing expertise, etc., will tend to gravitate toward the states, while those functions in which federal agencies or private firms enjoy a comparative or absolute advantage will end up in the proper hands as well through the market mechanisms proposed in this paper, that is, either through auctions or secondary trading.

Another important advantage of secondary markets (and auctions, for that matter) is that such a market-based approach promises to achieve the “optimal level” of governmental regulation, whether state, federal, or private.⁵⁰ In essence, by requiring each relevant agency or firm to purchase its regulatory powers, either through auctions or secondary markets, the resulting prices will be set by the demand for such regulations and the number of potential suppliers.⁵¹ That is, prices would reflect the individual choices of many actors and also aggregate each participant's private information.⁵² As a result, the potential purchasers of such regulatory powers will have less of an incentive to oversupply (or undersupply, for that matter) their law-enforcement/public-goods-provision services since trading in such regulatory powers will reflect these objective supply and demand conditions.

A third advantage of this approach is that it should reduce the number of legal disputes over the question of federalism.⁵³ In general, a system of well-defined and transferable property rights reduces wasteful disputes over ownership by keeping track of who owns what resources and allowing such resources to gravitate toward their highest-valued uses.⁵⁴ When property rights are poorly defined or under-enforced,⁵⁵ in contrast, resources are dissipated in unproductive squabbles over ownership.⁵⁶ Worse yet, poorly-defined/under-enforced property rights produces a

50. See Coase, *supra* at 43–44 (1960); Coase, *supra* note 32 at 390.

51. See generally F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 526 (1945).

52. See LIEBERMAN & HALL, *supra* note 48 at 331–32; e.g., Robert G. Natelson, *The Enumerated Powers of States*, 3 NEV. L. J. 469, 481–83 (2003).

53. LIEBERMAN & HALL, *supra* note 48 at 321; see NOZICK, *supra* note 19 at 276–77.

54. NOZICK, *supra* note 61 at 276–77.

55. See LIEBERMAN & HALL, *supra* note 48 at 321 (2nd ed. 2005).

56. Nozick, *supra* note 19 at 276–77.

vacuum in which more people end up “defecting,” that is, devoting more time and energy to stealing resources from others, instead of producing socially useful goods and services.⁵⁷

Nevertheless, many technical as well as philosophical objections may impede the creation and operation of these proposed system federalism markets. This paper now proceeds to highlight and discuss both sets of objections.

IV. TECHNICAL AND PHILOSOPHICAL OBJECTIONS TO FEDERALISM MARKETS

A. Technical objections

There are several potential problems with the proposed system of federalism markets. One possible pitfall, especially with the decentralized mini-auctions, is the problem of asymmetrical information.⁵⁸ Since each agency would simultaneously participate in as well as conduct its own auctions, it would have access to and direct control over competing bids and would thus be privy to the bids of its competitors.⁵⁹ Thus, it could be argued that the auctioning agency would enjoy an unfair informational advantage over its competitors. Nevertheless, this informational problem could be remedied through an auction clearinghouse or other neutral mechanism. Instead of submitting bids directly to the auctioning agency itself, all bids would be sent under seal to an independent clearinghouse. Each agency would still auction its functions, but a clearinghouse would receive the resulting bids and would not reveal them until after all bids were duly submitted.

From the state or local perspective, another possible problem with the use of federalism markets is the free-rider or collective-action problem.⁶⁰ One could argue that massive and well-funded federal agencies would be able to consistently and systematically outbid smaller state agencies and private firms in the rough-and-tumble competition for regulatory rights. How could multiple state agencies coordinate their efforts to overcome the collective-action problem and compete with federal agencies? Again, a clearinghouse or other aggregation mechanism should

57. MILGROM, *supra* note 35, at 247–49 (2004).

58. *Id.* at 248–49.

59. LIEBERMAN & HALL, *supra* note 48 at 331–32.

60. *Id.* at 357.

be able to remedy this potential collective-action problem.⁶¹ Many regional as well as national state-level organizations already exist for this purpose, such as the National Governors' Association (NGA), the National Association of Regulatory Utility Commissioners (NARUC), and the North American Gaming Regulators Association (NAGRA), just to name a few. These existing organizations (as well as newly-created ones) would be able to coordinate and aggregate the resources of their members and thus effectively compete with private firms and federal agencies in the federalism market.

Lastly, perhaps the most serious objection to this market-based approach is that federalism markets would be too "thin"—that is, markets with too few buyers and sellers.⁶² Thin markets are characterized by high volatility and high bid-ask spreads because when the number of buyers and sellers in a given market is small, each participant's share of the market is large relative to the overall market size, resulting in inefficient valuation of assets and high market volatility.⁶³ This potential thinness problem, however, could easily be corrected by opening the market for federal-state powers to private firms and by allowing multiple administrative agencies within the same level of government to participate in the federalism market as well. For example, one could imagine not only the federal Transportation Security Administration (TSA) but also other state and federal governmental agencies (such as Customs, the FBI, and State National Guards) as well as a large number of private firms bidding to provide airport security.

Furthermore, it is worth noting that the market approach for the provision of public goods, and the idea of property rights in governmental powers generally, is already fairly common in many countries around the world, specifically, the emerging practice of public-private joint ventures or so-called "public-private partnerships" (PPPs) in many vital sectors of the economy, including energy, telecommunications, transportation, as well as water and sanitation services.⁶⁴ Since a significant fraction of new large-scale infrastructure projects are now in the form of public-private joint ventures or PPPs, and since this trend is likely to continue into the

61. See, e.g., Marzena Rostek & Marek Weretka, *Thin Markets*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS (Steven N. Durlauf & Lawrence E. Blume eds., 2008), available at http://www.dictionaryofeconomics.com/article?id=pde2008_T000249.

62. *Id.*

63. See, e.g., F.E. Guerra-Pujol, *A Tale of Two Joint Ventures: Jiangsu, China, and Havana, Cuba: A Game Theoretic Analysis of Public Private Contracts in the Water Sector* 1–3 (2010) (unpublished manuscript) (on file with author) available at http://works.bepress.com/f_e_guerra_pujol/8.

64. See, e.g., Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092–93 (1972).

foreseeable future, these facts suggest that the above technical objections can be overcome and that the market-based model presented in this paper may potentially have a wide application.

B. Philosophical objections

Putting aside the technical objections to this proposed system of federalism markets, one must also recognize that certain legal entitlements—especially constitutional rights or so-called fundamental rights (i.e., “human rights”)—have historically been deemed as “inalienable” since the founding of the Republic.⁶⁵ But it should not be a foregone conclusion that some rights be treated as transferable assets and others not. After all, if such inalienable rights were truly “fundamental,” then presumably no one would ever be willing to buy or sell them in the first place. Oliver Wendell Holmes once remarked: “It is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV.”⁶⁶ But aside from legal tradition and the vagaries of history, what justifies the current, long-standing paternalistic view of federalism and constitutional rights generally? There are two possible philosophical objections to the idea of federalism markets (and trading in constitutional rights generally) and neither of these objections are particularly persuasive.

The principal argument against the transferability of constitutional rights, including the right to enforce rights, is that markets in certain types of goods and services might degrade or somehow undermine society’s most deepest and cherished values, such as human dignity.⁶⁷ Call this the “human dignity argument”—the classical Kantian argument that persons should be valued and respected as ends in themselves and not as means.⁶⁸ But putting aside the intractable level of generality problem—how does society go about defining the meaning of such a fuzzy, open-textured, and subjective term as “human dignity”?—the human-dignity argument is the easiest to refute and brush aside.

Consider the market for water and sanitation services. These essential utilities are no doubt necessary not only for human dignity and human flourishing but also for human survival.⁶⁹ Despite this fact, most governments not only impose fees for providing these essential services,

65. Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

66. *Id.*

67. JAMES RACHELS, *THE ELEMENTS OF MORAL PHILOSOPHY* (4th ed. 2002).

68. See, e.g., *id.*

69. Guerra-Pujol, *supra* note 63.

and many governments, including socialist ones, have been able to improve and extend water and sanitation services to poor communities through a wide variety of privatization mechanisms.⁷⁰ In other words, whether or not a certain right—whether it be the right to water or the right to enforce rights—should be tradeable depends less on utterly subjective moral or vague human dignity considerations than on the practical effects or consequences resulting from tradeability. In essence, water and sanitation networks as well as law-enforcement services are “public goods,” and there are costs and benefits to society of providing such public goods. The human dignity argument, standing alone, is simply irrelevant to the question of whether these public goods should be provided by a publicly-owned or privately-owned firm, or to the question raised in this paper: whether the right to provide such public services should itself be traded through a system of auctions and secondary markets.

Another argument against federalism markets is that the rights to be traded on such markets are “incommensurable”—that is, certain rights cannot be measured in dollars or otherwise quantified or measured on some scale.⁷¹ The incommensurability argument is a powerful one: not only is it morally wrong to commodify certain types of rights (i.e., non-market goods, such as the right to life), but it is also unfeasible to do so because there is no common metric for measuring or quantifying the economic value of such non-market goods.⁷² That is, even if there were no moral objections to commodification, it would still be impossible to accurately reduce non-market objects into monetary terms. Although this is a strong argument, it too is easily refutable (or, at least, rebuttable) for the following reasons: first, non-market goods can, in fact, be reduced to money value as a matter of routine.⁷³ Insurance markets and legal actors, for example, already perform this remarkable feat on a daily basis.⁷⁴ The classic example is the award of money damages in tort cases, in which judges and juries are required to put an economic value to human pain and suffering as well as to the loss of life and limb.⁷⁵ Likewise, the insurance industry could not exist but for its ability to monetize human life expectancy.⁷⁶

70. See, e.g., ELIZABETH ANDERSON, VALUE IN ETHICS AND ECONOMICS 52-55 (Harvard Univ. Press 1993)..

71. *Id.*

72. *Id.*

73. *Id.*

74. RICHARD A. EPSTEIN, CASES AND MATERIALS ON TORTS 783-87 (Aspen Publishers 8th ed., 2004).

75. See, e.g., Neil Duxbury, *Do Markets Degrade?*, 59 MOD. L. REV. 331, 336 (1996).

76. *Id.* at 335-36.

In addition, arguments based on the incommensurability of non-market goods (including related arguments based on “human dignity”) are themselves incommensurable, like disputes about aesthetics or religious doctrines, since such arguments are ultimately premised on highly-contested and utterly subjective underlying normative values. Simply put, moral problems are inherently insoluble because moral values themselves are incommensurable.⁷⁷ Of course, one could argue that market mechanisms are also based on a competing and thus incommensurable conception of morality, such as the idea of wealth maximization,⁷⁸ but at the very least, market mechanisms allow each participant in the relevant market to express her own personal moral preferences through her individual trading decisions, rather than having someone else’s moral preferences (however sincere or strong) imposed on her by preventing her from trading at all.⁷⁹

But perhaps the main weakness with both the incommensurability and human-dignity arguments is the inevitability of trade-offs.⁸⁰ In essence, these arguments appear to pretend that rights and non-market goods generally are somehow magically immune to the problem of trade-offs. But trade-offs are everywhere; even non-market goods must be traded off against each other.⁸¹ For example, there is no doubt that friendship is an incommensurable value, but in deciding how much time I should spend with my friends, I must still forego other competing and valuable uses of my time. Since trade-offs must also be made in the context of federal-state disputes over power, the question boils down to this: which institution should make these trade-offs? Markets or the legal system?

In closing, the three main advantages of a market-based approach to federalism are worth repeating: auctions and secondary markets not only promise to achieve the proper federal-state balance of power, they also promise to deliver the efficient or optimal level of regulation by avoiding too much as well as too little regulation.⁸² In addition, federalism markets promise to transform an essentially indeterminate constitutional question into a soluble economic problem.⁸³ In place of the longstanding, indeterminate, and unproductive constitutional dispute over the proper

77. Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 119–27 (1979).

78. See generally ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA (Basic Books 1974).

79. GUIDO CALABRESI & PHILLIP BOBBITT, TRAGIC CHOICES 92-93 (1978).

80. *Id.*

81. R.H. Coase, *The Market for Goods and the Market for Ideas*, 64 AMER. ECON. REV. 384, 384-86 (1974); Daniel Kahneman et al., 98 J. POL. ECON. 1325, 1325–26 (1990).

82. *Id.*

83. *Id.*

allocation of federal-state powers—a legal dispute in which the contending federal and state interests continually make self-serving and unfalsifiable assertions—each administrative agency would have to decide whether to purchase or sell (either through auctions or through secondary markets) its powers and functions.⁸⁴ Under this approach, markets—not courts or constitutional scholars—would solve the federalism problem.

V. CONCLUSION

This paper has attempted to outline a new approach to the problem of federalism, a market, property-rights approach. Although the idea of transferable or tradeable legal entitlements—and the underlying idea of property rights in legal entitlements generally—is not new, what is arguably new is this broad conception of such tradeable legal entitlements. This view of legal entitlements includes not only legal rights to perform certain actions as well as legal rights to prohibit third parties from performing certain actions, but also extends the Coasian concept of legal entitlements to include governmental power itself, that is, to the right to create new rights and to enforce existing rights. In summary, this market-based approach to federalism promises to transform an indeterminate constitutional question into a soluble economic problem. In place of the longstanding, indeterminate, and unproductive constitutional dispute over the proper allocation of federal-state powers, each administrative agency would have to decide whether to purchase or sell—either through auctions or through secondary markets—its powers and functions. Under this approach, markets—not courts or constitutional scholars—would solve the federalism problem.

84. R.H. Coase, *The Federal Communications Commission*, 2 J. L. & ECON. 1, 7 (1959); Coase, *supra* note 2 at 1 (1960).

