



AECR
ALLIANCE OF EUROPEAN
CONSERVATIVES AND REFORMISTS

In cooperation with



STUDY

**“THE RISE OF THE EUROPEAN REGULATORY STATE –
HOW TO FIGHT IT (BETTER)?”**

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EXECUTIVE SUMMARY

In this concise study we explore the rise of the regulatory state at the European level, its true causes and, last but not least, the ways how to fight this (better). This study has no intent to start a ‘holy war’ against regulation per se, nor does it want to attack the European Union for reasons of national sovereignty. But there is a clear intention to warn against a European regulatory system that seems to get out of control in producing ever increasing flows of regulations, resulting in rising pressures on our daily lives. ‘Europe’ cannot make the same mistakes as many Member States did during the rise of their welfare states, especially when the democratic control on government is more difficult in the EU than in its Member States.

So indeed, this study considers the – apparent but difficult to measure – continuous and seemingly uncontested rise of regulatory pressures coming from the EU (thus the concept of the ‘European regulatory state’) as worrisome for society. The reasons why are explained in chapter I.A. by zooming in on the (sometimes hidden) costs of the (European) regulatory state. The costs are not only economic, but also moral in nature. Well known are the compliance costs for companies and the ‘dead weight’ or efficiency losses for the economy as a whole, but less acknowledged are the moral hazards and (risks of) political favouritism that impede entrepreneurship, market exchanges, productivity growth, innovation, and therefore economic growth, more welfare and sustainable employment.

Next, we look for the main causes of this unfortunate rise. The second chapter (I.B) first deals with the ‘usual suspects’ which are explained in the literature of welfare economics: the four ‘market failures’, namely the existence of monopolies, the lack of production of public goods, the disturbing effects of (negative) externalities and the problem of information asymmetries. But these market failures, though to some extent correct in theory, are in reality and in the longer run, not so harmful as they might seem and therefore do not need repair by regulations. These theories of market failures also obscure the real main drivers of regulatory action: the zero-sum oriented political actors and their actions, as described in the ‘Public Choice’ theory. If these ‘government failures’ are not kept under control, Mancur Olson will be right that nations will indeed decline, as many European countries are now experiencing.

In the following chapter (I.C), we deal with the question how to fight this fundamental trend of the ever growing regulatory state due to political forces. The first promising way to do this was the introduction of the Impact Assessment in the EU in the early 2000s. But on closer look, its application now seems to hit an invisible ceiling, and its usefulness in making ‘better regulation’ is put more and more in doubt. The reason for this ‘plateau-ing’ of RIA can, on the one hand, be found in the political environment and its public choice forces, in which the RIA has to operate. RIA will not stop the political elephant, one world expert in regulatory reform once stated. On the other hand, the intrinsic complexity of the required analysis to measure all the benefits and costs of a regulation for society, leads to an almost unavoidable vagueness of its results, leaving politicians too much room to manoeuvre in making their political deals.

Another, more classical, approach to mitigate these regulatory flows, as explained in chapter I.D, is the judicial review of the quality of regulations, where (higher) courts question the necessity, suitability, inevitability and proportionality of legislation for society. But the required analyses prove again to be very complex by nature. Therefore their results are not so clear and undisputed to rely on. Courts also fear that they have to perform the same political balancing of benefits and costs of regulation for society, as the parliaments and governments did when designing the regulation, and therefore being accused as a non-elected and therefore undemocratic ‘gouvernement des juges’. So, courts are quite reluctant to walk this line and will only in very clear cases of power abuse annul legislation, leading to judicial deference.

Still, some kind of judicial review is needed to balance the public choice drivers behind the rising flows of regulation. Who else is legally able to stop or put a final check on the destructive public choice forces? How to strengthen the necessary ‘checks and balances’ and safeguarding the ‘rule of law’ in our democratic system? In order to provide the judiciary the tools to mitigate the complexity of the regulatory analysis, and a way of not falling in the trap of a judge-made government, the still valuable IA methodology needs to be refocused. Two proposals, behavioural law and economics and the legal theory of structuralism are discussed in chapter I.E. but (partly) dismissed as insufficient.

For this reason the second part of this study suggests another judicial review of regulations by focusing on the protection of the ‘nomocratic’ or classical individual basic rights of, for example, property or free contracting, against the ‘telocratic’ or policy-driven regulations. We first explain in chapter II.A the fundamental differences between the ‘nomocratic’ laws or rights, like property and free entrepreneurship, and the ‘telocratic’ regulations in order to realize all kinds of ‘social goals’, as described by Oakeshott and Hayek. We also explore why, combined with the drivers of the public choice theory, the inflation of ‘telocratic’ regulations will inevitably lead to an undermining of individual liberties and of the ‘nomocratic’ legal stability within society.

In the next chapter II.B, we provide a short analysis and appraisal of the EU experience on ‘regulatory takings’ and compare it with the (more extensive and developed) case law of the US Supreme Court. We (regrettably) notice that in both cases the judicial protection or safeguarding of property rights seems to be weak. Though more thoroughly than the judicial review of regulatory quality, the rulings of courts show a substantial deference towards policy-made breaches of property rights, especially in socio-economic matters. It seems to illustrate again the discomfort of courts and judges with the economic analysis on the one hand, and their fear of having to make political judgements on the other.

In order to strengthen this judicial protection of individual (economic) rights, we design in chapter II.C an analysis framework for a better judicial review, based on the crucial difference between the nomocratic law and the telocratic legislation. We begin by explaining some fundamental insights from the New Institutional Economics that provide an answer to the defaults in the classical welfare economics. Next, we integrate these views in a ‘nomocratic RIA’ which is a RIA that checks the impact of telocratic regulations on the nomocratic rights and legal order. We show how this nomocratic RIA will not only protect individual rights but can also stop the growing flow of regulations, so improving the general regulatory quality.

In chapter II.D, we illustrate the possibilities of the ‘nomocratic’ RIA with a short specific case study of a particular EU legislation: the protection of consumers in the financial sector. We first describe the IA that accompanied the legislation, analyse its defaults, and then illustrate how a ‘nomocratic’ RIA would perform the analysis.

But a nomocratic RIA can only work in reality if courts dare to do their job when reviewing EU legislation: analysing the legislation more profoundly in a ‘nomocratic’ way, thereby protecting our constitutional liberties. First, the ECJ and their rulings need to acknowledge the damages that telocratic regulations cause for the proper functioning of our economic and societal life. They have to understand how precarious institutions are for entrepreneurship and risk-taking. Next, the ECJ must accept its crucial role in upholding the fundamental legal order, even against the will of European legislators. Only when courts accept their constitutional duty to uphold the rule of law, even against the will of a political majority, the expanding European regulatory state can be stopped and their political drivers kept in check...

PART I.

THE RISE OF THE EUROPEAN REGULATORY STATE AND ITS CAUSES

Chapter I.A. The rise of the European regulatory state and its (hidden) costs

I.A.1. The rise of the European regulatory state

The rise of the European ‘regulatory state’ has been acknowledged by many scholars in the past decade and has now become undeniable. Ever more scientific studies and economic reports point at the steady growth of not only the amount of European regulations, but also, and more importantly, of its impacts on the daily occupations of citizens and businesses all over the EU, the so-called ‘regulatory pressure’. To illustrate, one scholar wrote: “Regulation is a normal activity of any government, and this is especially the case for the EU, which has amassed over 150,000 pages of regulation in the Single Market alone. The EU derives its legitimacy and activity from its legal framework, a fact that makes regulation even more important in the pursuit of its objectives.”¹ On September 6th 2004, a website stated, seemingly in an angry mood: “And the hyper-active regulatory machine in Brussels grinds on: in the first 11 months of 2003, for example, the EU has adopted 2,123 regulations and 111 directives.”² The perpetual increase of regulations appears s to frustrate many.

The growing flow of new regulations is also illustrated by the calculation by the Centre of European Policy Studies (CEPS) of the number of Impact Assessment between 2003 and 2009. This clearly illustrates that the rise in the number of regulations is actually happening in policy areas which are relatively ‘new’ for the European policy level, like transport and energy, environment, justice and safety, health and consumer protection, information society and employment, etc.. The usually given cause for a rising number of European regulations, namely the completion of the Internal Market by harmonizing national legislation, seems to play much less than one might think.



Source: presentation by dr. Andrea Renda

¹ Handacre A., “Better Regulation – What is at stake?”, Eipascope 2008/2, p. 5

² www.socialaffairsunit.org.uk/blog/archives/000157.php

These figures can also be divided per year, showing that there is a peak in the midterm (year 2007 and 2008) of the legislature 2004-2009, when the government is – sort to speak – at its maximum performance:



Source: presentation by dr. Andrea Renda

Counting the number of regulations or measuring the regulations in pages, is one thing, analysing the impact of regulations on society, the regulatory pressure or burden, is another, even more important issue. This is also acknowledged by a seminal report of OpenEurope on this topic when it writes: “The primary objective of the Commission must be to reduce the flow of regulation – which in practice means a new, clear commitment to ‘less regulation’. However, our results also show that it is the cost of regulation that imposes the biggest burden, not the number of regulations per se. This means that a new commitment to less regulation must imply less cost. As well as stemming the flow, meaningful deregulation also means simplifying and scrapping the most costly existing regulations rather than just ‘codifying’ or consolidating them to make them clearer. Most importantly, EU policy-makers must realise that regulation should be a last resort rather than a first option.”³ Not the amount of regulations *per se*, but the regulatory burden or pressure is crucial.

How much regulatory pressure exactly the European legislation produces, is still heavily debated. Based on an analysis by OpenEurope of more than 2,300 Impact Assessments which are produced by the British Government, it turns out that 71% of the regulation which was introduced in the UK since 1998, was originated in the EU, with a price tag of £124 billion for the British economy since then. In order to be clear: “this figure includes the recurring costs of the regulation, multiplied by the number of years it has been in force, and the implementation costs of the regulation, counted only once.”⁴ In other words, this figure represents the total amount of economic losses over a span of ten years.

The Dutch Central Planning Agency broadly supports these claims of European impact by publishing a study which states that nearly forty percent of the regulatory burdens on Dutch

³ OpenEurope (Gaskell S and Persson M), Still out of Control? – Measuring eleven years of EU regulation., 2010, p. 31

⁴ OpenEurope, o.c., p.7

companies have international and above all European roots or causes. And in a letter⁵ to the Dutch Parliament, the Ministry of Economic Affairs reports on September 19th of this year an increase of European regulatory compliance costs for Dutch companies with 1.2 billion euro, of which 700 million euro is caused by the European trading system for emission rights of greenhouse gasses. But other empirical calculations⁶ question the claims that more than half of the Dutch legislation has European origins and state that the correct figure seems to be much closer to fifteen percent. Next to this, a memo⁷ of the European Commission assessed the administration costs or information obligations of regulation at a staggering amount of 3.5% of GDP in the EU. So, compliance costs, efficiency losses and other more indirect costs of regulation for society are not even included in this high figure. But which numbers and analysis are now correct?

This confusion about the exact impacts of European regulation, and of national regulations more in general, on society is explained prof. Dieter Helm, expert on regulatory quality and reform of Oxford University when he writes: “Empirical estimates of the costs of regulation are few in number, and overwhelmingly produced by those with some interest in the outcome. All empirical estimates rely on a measurement of regulation – whether narrowly in terms of administrative costs or more generally tracing through the policy and therefore allocative effects. Remarkably, there are few reliable data. At a crude level, there have been weighting of liberalization of economies, where economies are ranked according to broad criteria, notably by the OECD. Attempts are then made to correlate ranking on these indices with economic growth performance and productivity levels and growth levels, through econometric studies.”⁸ In brief, the economic activities within a society are much too complex in order to calculate the exact impacts of regulations on them.

By the way, all this diverging studies and reports on the costs and origins of regulation were actually a reason for the OpenEurope study, as it explains the three reasons for this study:

- “The cost of regulation is generally poorly understood and most governments, including the UK’s, have an insufficient grasp of how regulation impacts on the wider economy and how much of their national wealth they spend through the regulations they adopt;
- There are few credible estimates of the annual cost of regulation comparable over time, meaning that policymakers have a hard time assessing whether their efforts to cut regulation are bearing fruit;
- The proportion of the cost of regulation coming from the EU is subject to fierce debate and is too often shrouded in ideological bias rather than based on hard data.”⁹

The report of OpenEurope looked at the issue from a different angle by measuring the annual cost of regulations, that is “the amount being paid each year for regulations that have been introduced between 1998 and 2009. The annual cost of regulations in, say, 2005 includes the recurring cost of each regulation introduced between 1998 and 2005, and the implementation costs of regulations introduced in 2005.”¹⁰ The importance of this approach is also made clear: “Measuring the annual flow of regulation [...] allows us to track changes in the regulatory environment, and most importantly, enables us to see whether the cost of regulation is going

⁵ See “www.sconline.nl/artikelen/details/2011/september/19”

⁶ Bovens M. and K. Yesilkagit, ‘De invloed van Europese richtlijnen op de Nederlandse wetgever’, in: Nederlandse Juristenblad, jrg. 80, 2005, nr. 10, pp. 520-529

⁷ MEMO/06/425 of 14 November 2006

⁸ Helm D., ‘Regulatory reform, capture, and the regulatory burden’, Oxford Review of Economic Policy, 22(2), 2006, p. 175-176

⁹ OpenEurope, o.c., p. 4

¹⁰ OpenEurope, o.c., p. 7

up or down.¹¹ This figure is indeed more suitable to monitor the regulatory pressure over time.

The report draws some important conclusions about the rise of the European regulatory state: “In 2009, the cost arising from regulations introduced since 1998 was £32.8 billion. 59 percent, or £19.3 billion, of this amount is EU-derived. This is an increase of 4 percent on the EU cost in 2008, which then stood at £18.5 billion. The EU proportion varies from year to year – from 59 percent in 2009 to 82 percent in 2001 – reflecting that the cost stemming from EU regulation tends to be cyclical, depending primarily on one-off costs arising from Directives, which usually take two to three years to implement from the date they have been agreed. Although still going up, the increase in the cost of EU regulation is slowing, which may be an indication that the EU’s Better Regulation Agenda is starting to pay off. This is an encouraging sign and policymakers in Brussels and Whitehall should be acknowledged for it. However, there are several costly EU regulations in the pipeline which could produce a spike in the cost of EU regulation in two or three years’ time.”¹²

So, the EU is not yet of the hook, quite on the contrary. To our personal opinion, the regulatory pressure in the EU will probably even increase in the (near) future, due to

- the completion of the harmonizing Internal Market in ever more new domains, as also acknowledged in the Monti-report on the strengthening of the European Internal Market (cfr. the “Interstate Commerce Clause” in the US);
- a decrease of budget for social and environmental policies, probably leading to a shift towards more regulations enforcing those policies;
- the intensifying power struggle between the European Commission, the Council and the European Parliament, leading to an “advance bidding” in ever more regulations.

To be clear, OpenEurope is not opposed to European regulations *per se* as it writes: “However, there are also clear benefits stemming from EU regulations and, overall, the benefits of being part of the EU’s regulatory regime – and therefore the Single Market – could well outweigh the costs on pure economic grounds. Some regulations emanating from Brussels serve to free up markets, improve consumer protection, reduce costs and so forth. But there are also a large number of cases where the benefits of a piece of EU regulation are clearly outweighed by the costs. This is particularly true in certain policy areas, such as social policy which has inappropriately become part of the EU’s Single Market jurisdiction. These are the areas where deregulatory efforts should be targeted.”¹³ Here, we can already see the main thesis of this study: the crucial distinction between good (‘nomocratic’) EU legislation on the Internal Market and the bad (‘telocratic’) EU regulation that tries (sometimes in vain) to attain all kinds of (social) policy goals. We will develop this thesis in full later on.

The OpenEurope report identifies some reasons why this ‘deregulation’ must happen: “As we noted before, the disproportionately high cost for EU regulation is not surprising, given the nature of EU law. Unlike national legislation, once an EU regulation is decided it is very much set in stone, even it proves overly burdensome or inappropriate in light of evidence and experience. Changing an EU law requires the reopening and successful conclusion of negotiations with all 27 member states and the European Parliament – which is very hard to achieve (and a government may even lose concessions it previously has won). New and existing EU laws can therefore continue to generate heavy policy costs every year and still be left unaddressed. In addition, EU regulations – even when coming in the form of Directives – are one-size-fits-all solutions which cannot fully accommodate individual national

¹¹ OpenEurope, o.c., p. 8

¹² OpenEurope, o.c., p. 8-9

¹³ OpenEurope, o.c., p. 10

circumstances. If not adjusted to the existing regulatory framework in a member state, EU laws can add a disproportionate – and unnecessary – burden.”¹⁴

Some also point at the distortive distributional effects of regulation by which some loose more than others. First, there is a clear ‘regulatory capture’ (on which we will go in detail later on in this study). Bad regulation is a particularly fertile area for ‘regulatory competition’, that is the ability of companies to exploit regulation to their competitive advantage through, for example, standard setting, setting agendas and procuring enforcement proceedings against competitors). Next, there is also the distortion of the normal market structure of big and smaller companies: “It is also widely recognised that the sector most impacted by ‘bad’ regulation is the Small and Medium-sized Enterprise (SME) sector, which is possible the most fragile, sensitive and simultaneously important sector for the future of the EU economy.”¹⁵ In short, not everyone loses as much, and some may even win at the expense of others, and therefore, aggregate assessments are not so precise.

Interestingly, the US also appears to be suffering from the same problem as the EU, as The Economist wrote in a quite recent editorial: “The problem is not the rules that are self-evidently absurd. It is the ones that sound reasonable on their own but impose a huge burden collectively. America is meant to be the home of laissez-faire. Unlike Europeans, whose lives have long been circumscribed by meddling governments and diktats from Brussels, Americans are supposed to be free to choose, for better or for worse. Yet for some time America has been straying from this ideal. Two forces make American laws too complex. One is hubris. Many lawmakers seem to believe that they can lay down rules to govern every eventuality. Examples range from the merely annoying (eg, a proposed code for nurseries in Colorado that specifies how many crayons each box must contain) to the delusional (eg, the conceit of Dodd-Frank that you can anticipate and ban every nasty trick financiers will dream up in the future). Far from preventing abuses, complexity creates loopholes that the shrewd can abuse with impunity. The other force that makes American laws complex is lobbying. The government’s drive to micromanage so many activities creates a huge incentive for interest groups to push for special favours. When a bill is hundreds of pages long, it is not hard for congressmen to slip in clauses that benefit their chums and campaign donors. The health-care bill included tons of favours for the pushy. Congress’s last, failed attempt to regulate greenhouse gases was even worse.”¹⁶

A specialised think tank Mercatus, based near Washington DC, published some interesting studies on this topic. In one study, it criticized severely the regulatory burden in the US, due to federal regulations:

* “Business and workers are harmed, however, by too many poorly produced regulations.

Today’s regulatory system is so onerous and complex that it forces employers to focus on the minimum necessary compliance, rather than the optimal means for protecting public health and safety.

* In FY 2011, the Office of Management and Budget’s report on regulations noted that over 3700 rules were finalized, out of which 54 were major rules having an estimated economic impact of \$100 million or more per year.

* Research shows that too many regulations – particularly highly detailed ‘prescriptive’ rules – can actually make Americans less safe. Occupational psychologists and economists find that subjecting workers and management to too many rules causes ‘regulatory overload’. This results in reduced compliance, less innovation, and increased uncertainty.”

¹⁴ OpenEurope, o.c., p. 10

¹⁵ Hardacre A., o.c., p.5

¹⁶ The Economist, February 18th, 2012, editorial, p. 8

* Attempting to comply with too many rules is harder for small businesses because they don't have the resources and internal bureaucracy that large firms use to handle regulatory compliance.

* Businesses today face two kinds of regulatory uncertainty. First, the sheer volume of rules on the books today creates uncertainty on what to comply with and how. Second, the rules are never final; it's a struggle for businesses to keep up with new rules and changes to existing rules."¹⁷

This brings us to the conclusion that the rise of the regulatory state is a phenomenon which is happening everywhere, even in 'the land of the free'. So, despite the complexity of and discussion about the empirical data of regulatory pressures in the EU, prof. Helm concludes, "[i]t has, however, also been shown that there are good theoretical reasons for expecting the regulatory burden to be excessive, and hence a critical approach to existing and future regulations is the appropriate policy stance."¹⁸ Therefore, it is scientifically correct to summarize the situation of the costs of (bad) regulation: "Indeed, 'bad' regulation creates unnecessary bureaucracy, adds to business costs (which, in turn, adds to consumer costs), inhibits competition, damages SMEs, creates barriers to entry into markets and can prove to be expensive, it not impossible, to enforce – all of which reduces welfare in society."¹⁹ But how bad this all may seem already, on closer look, these costs are just the tip of iceberg. Much more costs of regulations for society remain under the visible surface of the water.

I.A.2. Regulatory pressures: economic costs and moral hazards of the regulatory state

The most clearly visible costs of regulations are the compliance costs and administrative burdens. These are all costs legal subjects need to make to comply with the new regulation. Less visible, but maybe even more important are the costs as a result of efficiency losses or dead weight losses on the one hand, and sometimes waiting costs as a result of authorisation schemes on the other. Normally, the measurement and assessment of these costs should more or less be done in the Impact Assessments at the EU-level, which show that the benefits of the proposed regulations outweigh the costs of it. But almost never taken into account in these Impact Assessments, is the undermining by the regulation of societal trust and economic entrepreneurship, based on private property rights and free contracting, as the cornerstone of economic growth and sustainable development.

The World Bank establishes a clear causal link between property rights and economic growth: "A fundamental premise of 'Doing Business' is that economic activity requires good rules that are transparent and accessible to all. Such regulations should be efficient, striking a balance between safeguarding some important aspects of the business environment and avoiding distortions that impose unreasonable costs on business. Where business regulation is burdensome and competition limited, success depends more on whom you know than on what you can do. But where regulations are relatively easy to comply with and accessible to all who need to use them, anyone with talent and a good idea should be able to start and grow a business in the formal sector. [...] Globally, more efficient regulatory processes often go hand in hand with stronger legal institutions and property rights protections. There is an association between the strength of legal institutions and property rights protections in an economy as captured by several Doing Business indicators (getting credit, protecting investors, enforcing contracts and resolving insolvency) and the complexity and cost of regulatory processes as captured by several others (starting a business, dealing with construction permits, getting electricity, registering property, paying taxes and trading across borders."²⁰

¹⁷ Mercatus centre, Policy guide, August 2, 2012, p. 14-15

¹⁸ Helm D., o.c., p. 177

¹⁹ Hardacre A. o.c., p. 5

Helm explains a first economic driver: “The next step is to consider the transmission mechanism from higher levels of regulation to economic performance – via productivity and economic growth. [...] [T]he first causal mechanism is from regulation to productivity. If regulation increases costs – either of capital or labour – in effect, it is a tax. Higher costs reduce output, and also lead to a competitive disadvantage in the traded sector if rivals are less heavily regulated. Conversely, if regulation reduces costs [...], there is a potential competitive advantage. If the net effect is an increase in costs, reducing the productivity of factor inputs, this has an impact on economic growth. The causal mechanism from regulation to productivity feeds through into economic growth. [...] Endogenous growth theory injects a positive theory of technical progress and the determination of the factor inputs. Regulation therefore is endogenous too, in that it affects growth in so far it affects these variables. The effect is – as with the impact on labour and capital costs – ambiguous.”²¹

Recent empirical research provided some confirmation of these causal mechanisms: “Our results indicate that government regulation of business is an important determinant of growth and a promising area for future research. The relationship between more business-friendly regulations and higher growth rates is consistently significant in various specifications of standard growth models, and more consistently so than other determinants commonly used in the growth literature. [...] Our results also have significant implications for policy. They suggest that countries should put priority on reforming their business regulations when designing growth policies.”²²

But these explanations of the impact of regulation on economic growth don't go far enough. For a long time, the theory of economic growth did not take this aspect of societal trust into consideration: “Why can some countries show a prominent and persistent track-record of economic prosperity while others can not or to a lesser extent? Standard growth theory identifies the accumulation of physical capital, investment in human capital and (endogenous) technological progress as driving forces behind aggregate production. But then the question remains: why do some countries invest more in skills and equipment than others? Or, given the accumulated stock of human and physical capital, why do some countries succeed in a more efficient use of the existing factors of production, thus raising productivity?”²³ What triggers investment and innovation, leading to economic growth

Only quite recently, interesting views on this topic popped up: “The study of the impact of institutional arrangements on economic performance goes to the very heart of political economy, and has again become topical in the economic literature since the seminal paper of Barro (1991). Since then, an important strand of literature has moved into the direction of the institutional features of countries. [...] Broadly defined, the institutional infrastructure of a country refers to the set of arrangements that shape the ‘rules of the game’ and the incentives for the economic agents. [...] These incentives can encourage productive activities such as the accumulation of skills, investments in physical capital and also the development of product- and process-innovations. On the other hand, the institutional setting may give leeway to predatory behaviour (theft, rent-seeking, corruption, political stability,...).”²⁴

Prof. Wim Moesen, a leading scholar on the topic of ‘social capital’, identifies two specific causal links between regulations, which is an institution, and economic growth: “[O]ur total

²⁰ World Bank, Doing Business in a more transparent world – comparing regulation for domestic firms in 183 economies, Washington, 2012, p. 2

²¹ Helm D., o.c., p. 175

²² Djankov S. and others, Regulation and Growth, The World Bank, March 6 2005, p. 4

²³ Moesen W. and Cherchye L., Institutional infrastructure and economic performs: Levels versus catching up and frontier shifts, Center for Economic Studies, Discussions Paper Series 03.14, December 2003, , p.3

²⁴ Moesen W., o.c., p. 3-4

factor productivity measures allow us to disentangle two ‘channels’ through which institutions can impact on TFP, viz.:

- The ‘factor accumulation’ effect; i.e., the fact that good institutions enhance factor accumulation. For example, we can reasonably expect that a favourable institutional infrastructure will foster investments in human capital and increase the stock of physical capital both from investments at home and from abroad.
- The ‘factor accommodation’ effect; this refers to the role of institutions as the ‘lubricant’ of the economic system. Good institutions can be expected to improve the efficient use of the available stock of the production factors (capital and labor). Loosely put, good institutions ‘grease the wheels’ of the economic system. They accommodate economic exchanges with ‘saving’ in terms of transaction costs and diversion. Good institutions facilitate complex transactions, specialization and flexibility while reducing transaction costs in the sense of the costs of the economic system. This is especially apparent in the literature on (asymmetric) information, incentives and contracts, which explicitly recognizes the role of institutions as setting the ‘rules of the game’. The functioning of good institutions in terms of reducing transactions costs and diversion also shows from their interpretation as a society’s ‘social capital’.²⁵

Next, Moesen has put this theory to the empirical test and concludes: “Our empirical findings suggest a significant combined accumulation and accommodation effect, which falls in line with the existing literature. More interestingly, our evidence also supports a significant accommodation effect. In other words, better institutions do not only attract more investments, they also contribute to ‘fine-tuning’ the coordination of the available capital and labour stock (e.g., by facilitating economic transactions). This ‘superadditionality’ of the accumulation and the accommodation channel seems to hold for productivity levels as well as for productivity changes. A further decomposition of the institutional impact on productivity changes reveals that good institutions stimulate catching up as well as innovative activities. When looking at the effect of the different components of our overall institutional measure (political stability, government quality and social infrastructure), we identify a particularly strong case for instituting a high-quality government, which is here quantified in terms of a low black market premium, a low degree of corruption and a well-established tradition of law and order.”²⁶

On closer look, there exist even deeper causal links between good regulations or institutions and the improvement of the social capital within a society: “This emphasis upon invention and creativity is the distinctive characteristic of the capitalist economy. The capitalist economy is not characterized, as Marx thought, by private ownership of the means of production, market exchange, and profit. All these were present in the pre-capitalist aristocratic age. Rather, the distinctive, defining difference of the capitalist economy is enterprise: the habit of employing human wit to invent new goods and services, and to discover new and better ways to bring them to the broadest possible public.”²⁷ The question now is how this spirit of enterprise can flourish within a society.

Moral philosopher Michael Novak understands that the advantages of capitalist economic order are usually explained in a utilitarian way, and he agrees with it: “It is easy to understand why the practical case for capitalism is easy to grasp. No other system so rapidly raises up the living standards of the poor, so thoroughly improves the conditions of life, or generates greater social wealth and distributes it more broadly. In the long competition of the last 100 years, neither socialist nor third-world experiments have performed as well in improving the

²⁵ Moesen W., o.c., p. 4-5

²⁶ Moesen W., o.c., p. 26

²⁷ Novak M., Wealth & Virtue – The moral case for capitalism, National Review Online, February 18 2004, p. 4

lot of common people, paid higher wages, and more broadly multiplied liberties and opportunities. [...] A second practical argument is also widely accepted. Every democracy on earth that really does protect the human rights of its individual citizens is based, in fact, upon a free capitalist economy. Empirically speaking, there is not a single contrary case. Capitalism is a necessary condition for democracy. A free polity requires a free economy. It certainly needs a dynamic, growing economy if it hopes to meet the restless aspirations of its citizens.”²⁸

But Novak explains that these two advantages are not enough to safeguard it: “These two practical arguments in favour of a capitalist economy are powerful. But they do not go to the heart of the matter. One could admit that, yes, capitalism does work better for improving the living standards of ordinary people, stocking the shops with goods of abundance, and imparting broad upward mobility and economic opportunity from the bottom of society. And one could admit further that, yes, capitalism is a necessary condition for the success of democracy, since without economic progress in their own daily lives ordinary citizens will not love democracy. No one will be satisfied merely with the right to vote for political leaders every two years or so, if living standards decline. One could agree with all this. And still one could say: ‘But capitalism is not a moral system. It does not have high moral ideals. It is an amoral, even immoral system.’”²⁹

And yet, a capitalist economic order has some basic moral functions, as explained by institutional economists W. Kasper and M. Streit: “Peace in a community tends to be enhanced when potential conflicts are depersonalised by rules that commit the members of the community to non-violent conflict resolution. One way of depersonalising interpersonal or intergroup conflicts is to reduce to the minimum the areas that are decided by the collective action by governments, namely ensuring that life, the institutions and material assets are protected, as well as funding the administration of this protective function of government. The allocation of incomes and property and production are then left largely to the impersonal mechanisms of market competition. When these functions become politicised, collective antagonism can easily take hold and emotions can be whipped up by political operators to bind political factions together. This is rarely conducive to internal peace.”³⁰

Kasper and Streit continue by developing the essential peacekeeping nature of a free market: “One important function of economic rivalry in markets is that the power of individual and corporate suppliers and buyers is contested and controlled by their peers. Competition not only controls economic power, but also political power that flows from monopoly positions. Another function of competition in markets is to make the control of performance impersonal: sellers undertake self-seeking but voluntary efforts to satisfy potential buyers. Those sellers who cannot obtain prices sufficient to cover their production and transaction costs – in short, who fail to make a profit – will be inclined to attribute their failure to the anonymous forces of the market, rather than blaming other specific competitors or buyers. This means the depersonalisation of the ever-present conflict between sellers, who want a higher price, and buyers, who want a lower price, a circumstance that makes an important contribution to securing peace, both within countries and in international relations. People from very different cultural backgrounds and with little in common can interact beneficially and peacefully as long as they deal with each other in markets. With time, they may learn from each other and even gain respect and a liking for each other. By contrast, directives and controls imposed by political processes often emotionalise matters and create divisions which political agents exploit (Sowell, 1990). [...] The depersonalisation of the conflicting economic interests can only occur if competition is widely accepted as an ordering principle, which also means that

²⁸ Novak M., o.c., p. 2-3

²⁹ Novak M., o.c., p. 3

³⁰ Kasper W. and Streit M, Institutional Economics, Edward Elgar, London, 1998, p. 82

all its distributional and other consequences are accepted, and if political agents are kept from intervening. Once certain agents intervene to constrain the competitive process (for example, by forming cartels) or use their power to coerce (for example, by setting up barriers to market entry), peace and security are likely to suffer as conflicts become personalised, emotionalised and politicised.”³¹ So, without classical property rights, individual responsibility can not take root and the moral foundations of capitalism will falter. In other words, it is not the economy, but plain politics, stupid!

Chapter I.B. Sense and non-sense of its causes

I.B.1. The usual suspects: market failures

The question now is how to explain the self-sustaining growth of regulation. If too much regulation is so harmful for society, why does it keep growing? Helm does an attempt: “Why regulate? What is the rationale for regulation? The usual answer is that there is some identifiable market failure considered to be so great that intervention to correct it will be efficient, in the sense that the costs of intervention will be lower than the costs of the failure.”³² But is this true in reality?

Seven decades ago, the amount of regulation would not have been necessarily considered as problem: “The standard ‘public interest’ or ‘helping hand’ theory of regulation is based on two assumptions. First, unhindered markets often fail because of the problems of monopoly or externalities. Second, governments are benign and capable of correcting these market failures through regulation.”³³ In other words, the argument of the Pigouvian welfare economics is that regulations which solve or mitigate market failures, create huge benefits for society by enhancing the public welfare, which seem to dwarf the costs of it. Regulation is ubiquitous because market failures are

The first cracks in this vision of ‘welfare economics’ came in the 60s of the former century when scholars in the Chicago School of Law and Economics questioned the necessity and suitability of these government interventions: “First, markets and private ordering can take care of most market failures without any government intervention at all, let alone regulation. Second, in a few cases where markets might not work perfectly, private litigation can address whatever conflicts market participants might have. And third, even if markets and courts cannot solve all problems perfectly, government regulators are incompetent, corrupts and captured, so regulation would make things even worse.”³⁴

Therefore, when analysing the pros and cons of government intervention, one has to make the following considerations: “[A] market failure can be defined as an equilibrium allocation of resources that is not Pareto optimal – the potential causes of which may be market power, natural monopoly, imperfect information, externalities, or public goods. On what basis is one to conclude that a policy to correct a market failure is as successful as possible? The first consideration is whether government has any reason to intervene in a market: Is there evidence of a serious market failure to correct? The second is whether government policy is at least improving market performance: Is it reducing the economic inefficiency, or ‘deadweight’ loss, from market failure? Of course, the policy could be an ‘expensive’ success by generating benefits that exceed costs, but incurring excessive costs to obtain the benefits.

³¹ Kasper W. and Streit M., o.c., p. 82-83

³² Helm D., o.c., p. 171

³³ Schleifer A., ‘Understanding Regulation’, European Financial Management, Vol. 11, No 4, 2005, p. 440

³⁴ Ibidem

Hence, the final consideration is whether government policy is optimal: Is it efficiently correcting the market failure and maximizing economic welfare?”³⁵

In his seminal report “Market failures vs. government failures”, leading scholar in regulatory affairs Clifford Winston made an almost exhaustive evaluation of the effects of government interventions and came to the following overall conclusion: “Notwithstanding the potential for methodological disputes to arise when microeconomic policies are evaluated, my assessment of the empirical evidence reveals a surprising degree of consensus about the paucity of major policy successes in correcting a market failure efficiently. In contrast to the sharp divisions that characterize debates over the efficacy of macroeconomic policy interventions, I found only a handful of empirical studies that disagree about whether a particular government policy had enhanced efficiency by substantially correcting a market failure.”³⁶

Winston performed extensive research on the usefulness of government remedies for the four neo-classical market failures, and sees only one partial reason for government intervention: “In contrast to alleged market power abuses or imperfect information, externalities have caused serious social problems justifying government intervention. And government policy has in some cases made progress in curbing social costs. [...] The basic research question motivated by these stylized facts is whether government policy has generated significant net benefits in the process of reducing the social cost of externalities. The summary findings that I draw from the current state of the available scholarly evidence are: Some policies have been expensive successes although their benefits have exceeded costs, the gains have been achieved at much lower cost. Others have been outright failures because their costs exceeded benefits. In contrast, market-oriented approaches implemented by the government have shown promise of producing large improvements in social welfare by curbing externalities at lower cost than current policies do.”³⁷ Winston calls this ‘market robustness’.

Based on this empirical research, Winston comes to the following conclusions: “Market failure is less common and less costly than might be expected because market forces tend to correct certain potential failures. Competition develops to prevent market power in input and output markets from being long-lived and often develops in markets that are believed to have ‘natural’ entry barriers. [T]he effects of economic deregulation suggest that experience is more instructive than theory about whether effective competition will develop in particular markets.”³⁸ And he adds: “There is no question that many of the policy problems that government agencies face today are far more challenging than the problems they faced in an earlier era. In addition [...], policymakers’ performance has improved in some areas. Nonetheless, it is fair to say that although government agencies may strive to solve social problems, they have frequently contributed to policy failures by their short-sightedness, inflexibility, and conflicts. [...] The failure of agencies to adjust their policies appropriately to generate socially desirable outcomes occurs in many situations.”³⁹

On closer look, efficient regulation is clearly considered as a contradiction in terms. This efficiency perspective can therefore not explain the ubiquity of regulation. Why is there still so much regulation if private solutions are considered to be much more efficient in dealing with market failures? Summarized, “[t]he Pigouvian theory is undermined because market failures or information asymmetries do not seem to be necessary for regulation, yet those are seen by the theory as the prerequisites for government intervention. The Coasean position is undermined because free contracts are expected to remedy market failures and eliminate the

³⁵ Winston C., Government Failure versus Market Failure, AEI – Brookings Joint Center for Regulatory Studies, Washington, 2006, p. 2

³⁶ Winston C., o.c., p. 11

³⁷ Winston C., o.c., p. 42-43

³⁸ Winston C., o.c., p. 76

³⁹ Winston C., o.c., p. 79-80

need for regulation, yet regulation often intervenes in and restricts contracts themselves, including contracts with no third party effects.⁴⁰ In other words, the efficiency visions of both Pigou and Coase explains what kind of regulation should be, not what actually exists So, then what is real driver behind the ever increasing flow of regulations? And why is it so difficult to stop it?

I.B.2. The supply and demand of regulation and government failures

Scholar in European regulatory affairs Claudio Radaelli lifts a tip of the veil: “Although regulatory theories differ, standard justification for putting in place regulation is the existence of a market failure. Regulation is needed in the public interest, because the dynamics of certain markets mean that preferences cannot be adequately revealed. The possibility of failing markets also means that both over-supply and under-supply can occur, just like free-riding (under-paying) or externalities (under- or over-compensating). In reality, market failures are not the only failures. Government failures are another category of failures related to regulation: intervention by public authorities can have adverse effects, potentially worsening market failures or failing to achieve set public policy goals. Arguably, the occurrence of market failures and government failures is the reason why we need a specific policy dedicated to regulatory quality: Better Regulation. [...] These considerations have led many economists to accept the position that regulation is driven not by efficiency but by politics. Under the most prominent version of this theory, proposed by Stigler (1971), industries or other interest groups organize and capture the regulators to raise prices, restrict entry, or otherwise benefit the incumbents. Alternatively, regulation is just a popular response to an economic crisis, introduced under public pressure whenever market outcomes are seen as undesirable, regardless of whether there are more efficient solutions.”⁴¹

Economist Sam Peltzman clarifies the revolutionary importance of Stigler’s thinking: “What Stigler accomplished in his *Theory of Economic Regulation* was to crystallize a revisionism in the economic analysis of regulation [...]. The revisionism had its genesis in a growing disenchantment with the usefulness of the traditional role of regulation in economic analysis as a *deus ex machine* which eliminated one or another unfortunate allocative consequence of market failure. The creeping recognition that regulation seemed seldom to actually work this way, and that it may have even engendered more resource misallocation than it cured, forced attention to the influence which the regulatory powers of the state could have on the distribution of wealth as well as on allocative efficiency. Since the political process does not usually provide the dichotomous treatment of resource allocation and wealth distribution so beloved by welfare economists, it was an easy step to seek explanation for the failure of the traditional analysis to predict the allocative effects of regulation in the dominance of political pressure for redistribution on the regulatory process.”⁴²

Peltzman refines his point: “It is ultimately a theory of the optimum size of effective political coalitions set within the framework of a general model of the political process. Stigler seems to have realized that the earlier ‘consumer protection’ model comes perilously close to treating regulation as a free good. In that model the existence of market failure is sufficient to generate a demand for regulation, though there is no mention of the mechanism that makes that demand effective. Then, in a crude reversal of Say’s Law, the demand is supplied costlessly by the political process. Since the good, regulation, is not in fact free and demand for it is not automatically synthesized, Stigler sees the task of a positive economics of regulation as specifying the arguments underlying the supply and demand for regulation. The

⁴⁰ Radaelli C. and others , The implementation of regulatory impact assessment in Europe, Paper delivered to the ENBR workshop, University of Exeter, Exeter 27 and 28 March 2008, p. 3-4

⁴¹ Radaelli C., o.c., p. 2

⁴² Peltzman, S., ‘Toward a more general theory of regulation’, NBER Working Paper Series, 133, 1976, p. 1-2

essential commodity being transacted in the political market is a transfer of wealth, with constituents on the demand side and their political representatives on the supply side. Viewed in this way, the market here, as elsewhere, will distribute more of the good to those whose effective demand is highest. [...] In this view, ‘producer protection’ represents the dominance of a small group with a large per capita stake over the large group (consumers) with more diffused interests. The central question for the theory then becomes to explain this regularity of small groups dominance in the regulatory process (and indeed the political process generally).⁴³

But the story goes further than the role of pressure groups and emanated in the extension of the theory towards the two other main players in the political game. First, there are the politicians: “Political agents are, in most democracies, organised in a few political parties that engage in political competition for the periodic vote. Given the high information costs of voters, they will offer crude, general programmes. Where there are two parties or blocks of parties, they will focus their rivalry on the median voter, the floating voter. The bulk of voters who are committed or who shy away from incurring the transaction costs of making fresh voting decisions each time can be neglected. As a consequence, most political programmes focus not on the bulk of the principals, all the voters, but only on the decisive, floating minorities. This tends to distort political action to the detriment of the ‘silent majority’.

Political parties demand group solidarity and are able to enforce it by influencing candidate selection or re-election, as well as by expulsion of renegades from the party. The running of political parties nowadays requires massive funds to cover agency costs and advertising. The political interest is to get re-elected and gain the majority in parliament and dominance over the administration. Fund raising and the re-election motive may often lead to collective actions which are to the detriment of the citizens.⁴⁴

Add to this the role of bureaucracy, and the story of the ‘regulatory capture’ is complete: “The public-choice bias in modern states is also increased by another group, which did not figure in the traditional model of democratic government: the bureaucracy. Public servants have often a self-interest in regulating markets so that free private choices are overshadowed or replaced by public choices. They create specific institutions because such institutions confer power and influence on them. The observation that someone’s transaction costs are often someone else’s income applies. This leads to a bureaucratic deformation of the institutions and a displacement of internal institutions. Bureaucracies often enjoy information advantage. They cannot be effectively controlled by elected politicians, who are loath to incur the information costs. There is a tendency, given the complexity of modern economic life, for parliaments to create a framework of enabling legislation which allows bureaucratic experts to write the specific rules in the form of regulations. Where this tendency is strong, the rules proliferate and change frequently; the domain of free private choice is correspondingly curbed. The deluge of black-letter legislation and ordinances in all advanced countries, most of which originate in a self-centred bureaucracy, is testimony to that tendency.⁴⁵

Focusing on the rise of the European regulatory state, Radaelli explains why two possible causes for the apparent abundance of European regulations are to be found in the Public Choice theory and plain economic reasoning in the political sphere: “If the problem with regulation is that there is too much of it, this can have two underlying causes: either there is too much supply of regulation or there is excess demand of regulation⁴⁶. Bureaucracies can display tendencies to supply regulation in excess, because they are looking to expand either

⁴³ Radaelli C., o.c., p. 3

⁴⁴ Kasper W. and Streit M, o.c., p. 291

⁴⁵ Kasper W. and Streit M, o.c., p. 291-292

⁴⁶ For a detailed explanation of these arguments, see Helm, D. (2006) ‘Regulatory reform, capture, and the regulatory burden’, Oxford Review of Economic Policy, 22(2), 169-185

their budgets, their areas of intervention or their spheres of political influence. Politicians can also contribute to this excess supply, due to their basic incentive which is to win elections, not to produce good regulations. It is a common phenomenon for politicians to attempt to increase their popularity by attaching their names to the new laws. They want to be seen as responsive to public opinion, so if there is a growing concern about a problem, they intervene by adding a new rule.”⁴⁷ These are government failures which politicians usually don’t like to admit but which are key to understand the underlying reasons of excessive regulatory pressures.

Helm also points at the self interest of the organisations that have to implement the regulation: “Regulatory bodies have a direct incentive to oversupply regulation. Institutions have budgets and missions; their staff has salaries and careers. The former are related to the latter: in general, the bigger the budget, the greater the pay, non-pecuniary benefits, and scope for promotion.”⁴⁸ Finally, “most professions engage in some form of voluntary self-regulation, setting standards, and administering qualifications and certification. Professional trade bodies have incentives similar to the statutory regulatory bodies in respect of their staff and the additional incentive to restrict entry to the ‘club’ they regulate, through examinations, qualifications and other hurdles to membership, thereby increasing the fees of members.”⁴⁹

When applying these Public Choice views on the European Commission as the main originator of EU legislation, Radaelli makes the following observations: “In the case of the European Commission, re-election is not the concern (although arguable renewal of their mandates is a concern for individual Commissioners), but its very right to exist as a supranational institution whose power derives primarily from its regulatory functions, is. When it comes to regulating, the EU, and the European Commission as its only institution with the right to initiate legislative proposals, finds itself in a “damned if you do and damned if you don’t” situation. Complaints about European over-regulation are abound, but in many cases member states are only too happy to leave painful regulatory decisions to the EU, which in turn is keen on proving its added value by means of a steady regulatory output. This paradox is related to the problems of regulatory rent-seeking and capture [...].”⁵⁰ It seems that even technocratic governments create their own problems.

On the demand side, Radaelli notices considerable pressure to create more regulation, due to the perverse mechanism of ‘regulatory capture’ by lobby groups: “Excess demand for regulation by pressure groups and regulatory capture of regulators is a common phenomenon. Pressure groups demand regulation because it protects them from competition and produces ‘regulatory rents’ to those who are ‘inside’”⁵¹. A famous article of Buchanan and Tullock⁵² already mentioned the fact that even companies which bear the direct consequences of inefficient regulations, prefer these regulations above cost-effective policy instruments like environmental taxes. These regulations are perceived as better for keeping outsiders out.

Radaelli notices that pressure groups may capture regulators in different ways: “They may have more resources to invest in the analysis of the effects of regulatory proposals. They may have close links with the political masters of bureaucracies. They may even appeal to the media and argue that a certain regulatory intervention is in the public interest (or in the interest of certain weaker groups in society or possibly in the interest of the regulator), whereas in reality the main effects of the regulation will be to shield the stakeholder from competition. Pressure can be exercised either by individual firms or through organizations of

⁴⁷ Radaelli C. , o.c., p. 2

⁴⁸ Helm D., o.c., p. 173

⁴⁹ Helm D., o.c., p. 174

⁵⁰ Radaelli C., o.c., p. 2-3

⁵¹ Radaelli C., o.c., p. 3

⁵² Buchanan, J.M. and Tullock, G. (1975) ‘Polluters’ profits and political response: Direct controls versus taxes’, American Economic Review, 65, 139-147

employers – the best-organized firms use both channels. Small but well-endowed groups can indeed capture regulators rather effectively.⁵³ They have lower coordination costs to organize themselves and the rewards don't have to be shared by many.

The most typical example is a service provider or an independent worker, facing newcomers on the market that offer comparable services and thereby increase competition. Usually, the 'insiders' argue then that an introduction of licensing or even an exclusive statutory mandate is necessary because of safety, consumer protection or the preservation of tradition. It needs not much explanation to say that especially the European Parliament is susceptible for lobbying and regulatory capture. A striking example of these protectionist tendencies happened during the approval of the Services Directive by the European Parliament when the original proposal with its 'country of origin' principle was watered down and many additional professions were excluded for many 'good reasons of public interest' (from a socialist perspective of course).

And even if the government would plan to abolish the regulation, many of the target groups would oppose it for the reason that "[t]he excess supply is often entrenched by its economic effects: regulation has the implicit or explicit consequences that it changes prices, and hence tends to be capitalized in asset prices. Reducing regulation can lead to capital losses, and losers are likely to be more politically vocal than potential gainers."⁵⁴ In this respect, regulation becomes perverse by almost poisoning one time opponents of regulation into defenders of it. The same story seems also to be happening in the US: "Furthermore, the politics of removing regulations is harrowing. Each removal must go through the same cumbersome process it took to put the regulation in place: comment periods, internal reviews and constant behind-the-scenes lobbying. Ironically, regulated industries may actually not want regulations removed. They have sunk costs into compliance, and do not want those costs taken away to the benefit of upstart competitors."⁵⁵

Winston explains why: "What explains the prevalence of government failure when policymakers are presumably trying to correct market failures? In some situations, government failures arise because government intervention is unnecessary – that is, markets can adequately address their possible failures. Consequently, government intervention may prove to be counterproductive because market failure policies are flawed or poorly implemented and because policymakers, regardless of their intentions, are subject to political forces that enable certain interest groups to benefit at the expense of the public. In other situations, government action is called for but is again compromised by agency shortcomings and political forces. The fundamental underlying problem, as argued by Wolf (1979), is that the existence of government failure suggests the absence of an incentive to reconcile an intervention's costs and benefits to policymakers with its social costs and benefits. In contrast, it appears that in at least some instances market participants have greater incentives to correct market failures than then government has to correct these failures."⁵⁶

Radaelli summarizes: "One can argue that politicians want 'better regulation' for two reasons. Firstly, better regulation increases the legitimacy of the regulatory system, and this may have a positive impact on the popularity of the incumbent. Secondly, in open economies better regulation increases the competitiveness of a country. A good regulatory environment increases foreign direct investment and deters domestic firms from moving some high value functions abroad. This, in a context of regulatory competition, RIA is an important tool of economic reform. These are the two reasons provided by official documents of international

⁵³ Radaelli C., o.c., p. 3

⁵⁴ Helm D., o.c., p. 173

⁵⁵ Of Sunstein and sunsets, The Economist, p. 34

⁵⁶ Winston C., o.c., p. 75-76

organizations and governments.”⁵⁷ But he adds: “However, they rely too much on a benign view of elected politicians. Thus, a third explanation – rooted in positive political economy – starts from the assumption that elected politicians want to please rent-seeking firms that represent the core constituency of support for the incumbent. For these pressure groups, rents generated by domestic protectionist are preferred to profits (Buchanan and Tullock 1975). Hence, there will be no pressure for better regulation. What is the role played by RIA then?”⁵⁸

Chapter I.C. The limited success of the (Regulatory) Impact Assessment (RIA)

I.C.1. The complexity of the RIA

Two leading experts on RIA development and implementation, dr. Andrea Renda and Cesar Cordova-Novion claim that the added value of the (Regulatory) Impact Assessment in producing better regulation proves to be quite limited. Renda has a grim view: “[I]t is no mystery that so far the implementation of RIA has been a failure in most countries around the world. [...] Even if international organizations like the OECD often mention RIA as a practice that has successfully spread in most developed and several developing countries, the reality is that the formal adoption of the model has been followed by very limited and often awkward implementation attempts. Today, in virtually no country outside the US, RIA can be said to be a success, with the only, very partial exceptions of the European Commission and possibly the United Kingdom. This also means that there is no Civil Law jurisdiction where RIA has been successfully mainstreamed into the policymaking process to date.”⁵⁹

Confirmation is given from the other side of the Atlantic Ocean by the Mercatus centre, claiming that the US is not so successful: “Despite decades or presidential orders on the topic, agencies have consistently failed to produce useful measures of regulatory performance. Most recently, the Obama Administration urged agencies in 2011 to ‘measure, and seek to improve, the actual results of regulatory requirements’. Despite these clear instructions, the evidence indicates that agencies have not made any meaningful progress in this area.”⁶⁰

The actual quality check is abominable: “Since 2008, the Mercatus Center’s Regulatory Report Card has evaluated the quality and use of economic analysis accompanying all proposed rules having an anticipated economic impact of \$100 million or more. On a scale of 1 to 60 points, the Report Card evaluations show that the average score for proposed rules was 28 for the period 2008 to 2010. In 2011, the average score was a disappointing 29. That’s an ‘F’ for the last four years. On average, agencies scored the lowest on (a) defining the problem (a market failure, government failure, or other systemic problem that the proposed regulation is intended to solve), (b) identifying and considering alternatives to the regulation being proposed, and (c) establishing data collection and measurement standards to assess a regulation’s actual outcomes. [...] It is also important to note that the aggregate benefit-cost information is derived from a small percentage of all rules issued in any given year. In FY 2011, only 13 of 54 economically significant rules had quantified both benefits and costs. In FY 2011, a total of 3716 rules were issued, many of which had little or no benefit or cost information attached to them.”⁶¹ And finally: “Estimates of employment effects included in agency regulatory analysis are frequently unreliable. The estimates are often inconsistent with the rest of the analysis, inconsistent with basic economic theory, and incomplete in that they do not consider all the likely employment effects. [...] Without substantial improvement in

⁵⁷ Radaelli, C. o.c., p. 5

⁵⁸ Radaelli, C. o.c., p. 6

⁵⁹ Renda A., Law and Economics in the RIA World, Erasmus University, Rotterdam, 2011, p. 13-14

⁶⁰ Mercatus Centre, o.c., p. 15

⁶¹ Mercatus Centre, o.c., p. 17-18

theory and implementation, we cannot be confident that agency analysis of employment effects of regulations provides much meaningful information.^{”62}

This lack of RIA-quality and of economic analysis of regulations more in general, is also observed by the famous expert on regulatory affairs Hahn: “Despite the magnitude of the costs and benefits of regulation, the quality of government analyses of regulation falls far short of basic standards of economic research, and it does not appear to be getting better over time. Indeed, we do not even have answers to basic questions like whether benefit-cost analysis tend to overstate benefits, perhaps out of regulatory zeal, or whether they overstate costs, perhaps because they fail to recognize how innovation will reduce the costs after regulations are imposed. Furthermore, there is little evidence that economic analysis of regulatory decisions has had a substantial positive impact. This is not to say that economists have not had an impact in important areas, such as the deregulation of airlines, but that economic analysis of run-of-the-mill billion dollar regulations may not have had a substantial impact. My main argument is that the poor quality of analysis can help explain some of this ineffectiveness. However, I recognize that the impact of analysis also depends on the extent to which economists have a meaningful voice in the regulatory process. Regardless of how good the analysis is, politicians sometimes choose not to take basic economic ideas seriously, in part because they have different objectives. Nevertheless, it is important to give politicians access to sound analysis, so that it is implemented in the cases where economists can influence regulatory decision making.”⁶³

Yet, in the beginning, the RIA seemed to be very promising in improving the regulatory quality for several reasons. The first crucial reason is worded by Radaelli: “Macro-level observations about the quantity of regulation in a given political system give us little or no clues about the best way to reduce this. Regulations can be evaluated and improved only on the micro-level. Indeed, the case-by-case approach is one of the major strengths of impact assessment as opposed to programmes of administrative burden reduction.”⁶⁴ Moreover, RIA seems to provide a tool to capture the elusive nature of regulatory quality: “All the same, the notion of quality is elusive. Different stakeholders may have different notions of quality in mind. For some, quality is essentially another way to talk about efficiency. For others, quality refers both to the process through which a rule is formulated and the final economic outcome produced by the rule. Thus, quality in this perspective would capture efficiency as well as transparency, due process, and accountability. Finally there are those who have a more modest definition of quality: making sure are developed following the procedures of administrative law-making issued by cabinet offices. We can see a particular set of IA guidelines as an operational definition of quality: by saying what should be done and when, guidelines make the notion of quality more practical and operational.”⁶⁵

The question now becomes what causes this lack of success. Renda points at the intrinsic complexity of the Cost-Benefit-Analysis which is a crucial part of RIA: “In the United States, RIA is under attack mostly for reason related to the methodology it adopts to reach very socially relevant conclusions – in particular, I refer again to the use of Kaldor-Hicks Benefit-Cost Analysis in the assessment of so-called ‘lifesaving regulation’, including policy domains related to health care, safety, and the environment. In the EU and elsewhere, critiques of the RIA system currently focus both on issues related to governance and substance.”⁶⁶

⁶² Mercatus Centre, o.c., p. 19

⁶³ Hahn R. , ‘An evaluation of Government Efforts to Improve Regulatory Decision Making’, International Review of Environmental and Resource Economics, 2009, No 3, p. 250-251

⁶⁴ Radaelli C., o.c., p. 3

⁶⁵ Radaelli C., o.c., p. 5

⁶⁶ Renda A. , o.c., p. 13-14

On closer look, the problem of the limited added value of the CBA as part of the RIA goes at its very core of rationality. Torriti elaborates his statement by explaining the claim of rationality by the Impact Assessment methodology: “Textbooks on public policy traditionally refer to Impact Assessments as rational policy analysis instruments. Parsons (1995) defines Impact Assessment as the rational provider of evidence about the future costs, benefits and risks of each policy option for new legislative proposals. Evidence-based policy analysis instruments, like cost-benefit analysis and Impact Assessment, are also described as mechanical algorithms used to answer questions about policy decisions or ‘lusts after mechanical objectivity’ (Porter 1996). These definitions of Impact Assessment fall in the realm of rationality and find empirical grounds when looking at the structure of the EU template, which follows the logical construct of rational decision models. Hence, the EU system offers an appropriate platform to address the following questions: do rational applications of Impact Assessment follow from its rational structure and definition? Is Impact Assessment a rational instrument for policy-making?”⁶⁷

He continues to explain the underlying rationality of the RIA but arrives at a major problem: “The technique of multiplying the costs and benefits faced by the total population of firms has the merit of helping to provide actual figures for the impacts of legislative changes. This may produce a more systematic approach to making decisions, as well as simplify the multiple factors that go into a legislative decision. However, there is a significant problem with estimating costs and benefits for a distinct class of economic actors – or firms – and then expanding those findings to the whole population. [...] Similarly, the prisoner dilemma proves that an individual’s optimal choice may not be optimal for all players. Impact Assessment and, even more aptly, cost-benefit analysis are instruments for judging efficiency in cases where the public sector supplies goods, or where the policies executed by the public sector influence the behaviour of the private sector and change the allocation of resources. The aggregation of costs and benefits and their comparisons are problematic when involving both private goods [...] and the provision of goods for public use [...]. The rationale behind estimating costs and benefits for individuals lies in the concept of efficiency. However, the efficiency criteria on which Impact Assessments are based are significantly different from the Pareto efficiency criterion given by the Willingness to Pay – Willingness to Accept equation, because they have to take into account other policy priorities based on social and environmental values.”⁶⁸

Moreover, Renda notices another problem: “This leads to the third problem: when efficiency conflicts with other values, it becomes problematic to create an overall economic criterion that will integrate all values. [...] The combination of efficiency criteria, related to the market value of goods, and non-efficiency criteria, associated with the improvement of the environment, social and health conditions, is likely to cause confusion in those Impact Assessments applying cost-benefit analysis. [...] To summarise, Impact Assessments will probably never perform true cost-benefit analysis based on the efficiency criterion as ideated by Kaldor-Hicks if they have also to take into account conflicting priorities based on social and environmental values. The core of the problem, as pointed out by critics of cost-benefit analysis, rests in its failure to seize the macroeconomic societal benefits.”⁶⁹

Besides these methodological problems, there loom also difficulties on the empirical front which undermine the rationality claims of the RIA and CBA: “Thus far it has been explained how without adequate data rational economic predictions of future policy proposals cannot be carried out following an objective rationale. Objective unbiased ex post evaluations can only be carried out if data contained in the Impact Assessment are unflawed. If a lack or inadequacy of data enhances the probability of biases, subjective management and

⁶⁷ Torriti J., ‘The unsustainable rationality of Impact Assessment’, Eur J Law Econ (2011) 31, p. 309

⁶⁸ Torriti J., o.c., p. 313-314

⁶⁹ Renda A., o.c., p. 314

manipulation, then the European Commission Impact Assessment cannot be defined as rational and objective instruments of policy analysis.”⁷⁰

Torriti sums up the main problems of the current RIA application: “This paper pointed out that the rational design of Impact Assessments is not always observed in their applications:

1. Abnormalities regarding the consultation process and EU Impact Assessments are numerous and tend to contradict basic conditions for full awareness of policy options.
2. Market failure represents a controversial tool for identifying the problems related to the legislative status quo.
3. IAs’ output are dependent upon individuals’ personal knowledge and expertise.
4. The refusal to use the value of statistical life technique; the use of microeconomic instruments to understand macroeconomic impacts; and the combination of efficiency criteria, with non-efficiency criteria are factors that diminish the likelihood of efficient economic estimates.
5. The scarce quality of the data representing the evidence for an Impact Assessment compromises the consistency of impact assessment outputs and prevents unbiased ex post evaluations.”⁷¹

And he concludes: “Impact Assessment seems to work better as a tool to inform the reader about the content of policy proposals rather than as a process to increase the policy-maker’s knowledge about the policy problem. The predictive knowledge of economics is subordinated to the pressure to show that policy interventions are based on some empirical evidence. This is not negative in itself, unless policy alternatives are created merely to support implicitly a pre-determined regulatory line; unless the ideas put forward by stakeholders during the consultation process are never taken into account; and unless useful methods for estimating impacts have not been used, probably due to deficiencies in knowledge and expertise to officials. When any of these things happen Impact Assessments become merely procedural instruments that do not serve the purpose for which they were instituted.”⁷²

This conclusion brings Renda to warn against an undermining of the RIA analysis by political pressures: “The economic toolbox has at its core a framework for working out when to intervene. The rule is that intervention is justified if there are serious market failures, and if those failures are expected to have a greater efficiency cost than the cost of the intervention – government failure. [...] Faced with this balance, the appropriate tool for evaluating when to intervene is cost-benefit analysis (CBA), and the techniques have been extensively developed in the literature. Surprisingly, however, CBA is rarely used in policy and regulatory analysis. The efficiency reason is that CBA is costly itself, and the expected cost of conducting detailed CBA studies have been one reason why policy-makers have typically adopted more limited appraisal techniques. But there are other reasons, too: politicians and bureaucrats may not like the anticipated answers, preferring to enhance their ability to capture regulation by using more subjective techniques such as weighting and scoring.”⁷³ This latter reality brings us to the next, and even bigger threat for the RIA-quality: the ‘Public Choice’ drivers.

I.C.2. (R)IA in a ‘public choice’ environment

The intrinsic complexity of the RIA method and application seems to lead to additional government failures in applying the RIA and in abiding by its results, as claimed by Renda:

⁷⁰ Torriti J., o.c, p. 316

⁷¹ Torriti J., o.c, p. 317-318

⁷² Torriti J., o.c, p. 319

⁷³ Renda, A., o.c., p. 177

“The transparent use of economic analysis to back policy proposals often elicits the fierce resistance of elected political powers. Parliamentarians, for example, typically hate being constrained by any form of objective rationale when voting on policy proposals: rather, they prefer pursuing their own political agenda and strike deals between conflicting and often competing interests. Finally, and perhaps more importantly, the economic analysis of proposed legal rules is normally performed by civil servants in charge of a policy portfolio within a national administration: traditional ‘Weberian’ bureaucrats, however, typically do not possess enough knowledge to perform sophisticated economic analysis, and they, themselves, end up resisting the adoption of these tools.”⁷⁴

These political threats to RIA-quality are also recognized by Hahn: “Regulatory evaluation, particularly evaluation by some centralized governmental unit or agency, has been suggested as an effective mechanism for improving regulation. There are at least three reasons agencies may require centralized regulatory evaluation. One is that regulatory agencies may be captured by particular interest groups. A second reason is that regulators in single-mission agencies have a kind of a tunnel vision, where they tend to place undue emphasis on the particular set of problems they have been asked to address. If a person is working in an environmental agency, for example, she may tend to place too much emphasis on the environment relative to other worthy causes; the same logic would hold true for a professional in a defence agency or in homeland security. Regulatory evaluation has been suggested as a kind of antidote to problems of agency bias that may be caused by political factors, such as capture or tunnel vision. A third possible rationale for evaluation is that regulation may give rise to more regulation than is efficient.”⁷⁵

That this observation is not an abstract and far-away reality is clearly illustrated in a recent article in The Economist: “The minutiae of how regulators calculate benefits may seem arcane, but matters a lot. When businesses complain that Mr Obama has burdened them with costly new rules, his advisers respond that those costs are more than justified by even higher benefits. His Office of Information and Regulatory Affairs (OIRA), which vets the red tape spewing out of the federal apparatus, reckons the ‘net benefit’ of the rules passed in 2009-2010 is greater than in the first two years of the administrations of either George Bush junior or Bill Clinton. But those calculations have been criticised for resting on assumptions that yield higher benefits and lower costs. One of these assumptions is the generous use of ancillary benefits, or ‘co-benefits’, such as reductions in fine particles as a result of a rule targeting mercury. [...] Fully two-thirds of the benefits of economically significant final rules reviewed by OIRA in 2010 were thanks to reductions in fine particles brought about by regulations that were actually aimed at something else [...]. That is double the share of co-benefits reported in Mr Bush’s last year in office in 2008. If reducing fine particles is so beneficial, it would surely be more transparent and efficient to target them directly. As it happens, federal standards for fine-particle concentrations already exist. But the EPA routinely claims additional benefits from reducing those concentrations well below levels the current law considers safe. That is dubious: a lack of data makes it much harder to know the effects of such low concentrations.”⁷⁶

The story continues: “Another criticism of the Obama administration’s approach is its heavy reliance on ‘private benefits’. Economists typically justify regulation when private market participants, such as buyers and sellers of electricity, generate costs – such as pollution – that the rest of society has to bear. But fuel and energy-efficiency regulations are now being justified not by such social benefits, but by private benefits like reduced spending on fuel and

⁷⁴ Renda A., o.c., p. 11

⁷⁵ Hahn R., o.c., p. 248-249

⁷⁶ The Economist, “The rule more – measuring the impact of regulation Rule-making is being made to look more beneficial under Barack Obama”, p. 62

electricity. Private benefits have long been used in cost-benefit analysis but Ms Dudley's data show that, like co-benefits, their importance has grown dramatically under Mr Obama. Ted Gayer of the Brookings Institution notes that private benefits such as reduced fuel consumption and shorter refuelling times account for 90% of the \$388 billion in lifetime benefits claimed for last year's new fuel-economy standards for cars and light trucks. They also account for 92% and 70% of the benefits of new energy-efficiency standards for washing machines and refrigerators respectively. The values placed on such private benefits are highly suspect. If consumers were really better off with more efficient cars or appliances, they would buy them without a prod from government. The fact that they don't means they put little value on money saved in the future, or simply prefer other features more. Mr Obama's OIRA notes that a growing body of research argues that consumers don't always make rational choices; Mr Gayer counters that regulators do not make appropriate use of that research in their calculations."⁷⁷

And to complete the story: "Under Mr Obama, rule-makers' assumptions not only enhance the benefits of rules but also reduce the costs. John Graham of Indiana University, who ran OIRA under Mr Bush, cites the new fuel-economy standards as an example. They assume that electric cars have no carbon emissions, although the electricity they use probably came from coal. They also assume less of a 'rebound effect' – the tendency of people to drive more when their cars get better mileage – than was the case under Mr Bush. Mr Bush's administration was sometimes accused of the opposite bias: understating benefits and overstating costs. At one point his EPA considered assigning a lower value to reducing the risk of death for elderly people since they had fewer years left to live; it eventually backed down. Mr Obama's EPA has considered raising the value of cutting the risk of death by cancer on the ground that it is a more horrifying way to die than others."⁷⁸

Hahn provides us another example of (possible) political interference with the RIA-application: "Observers speculate that President Obama is contemplating an executive order that aims to ensure that regulations promote social justice. The executive order might change how executive agencies and OIRA account for the costs and benefits of regulation. Potential changes include lowering the discount rate of future environmental benefits to increase intergenerational equality and placing a heavier weight on regulations that benefit lower-income individuals. These changes could change the benefit-cost calculus and could also affect decisions. A lower discount rate would put a higher weight on benefits and costs that occur in the future relative to the present. It may be aimed at promoting greater 'intergenerational equity' for problems, such as climate change. Putting a greater weight on the welfare of low-income individuals would tend to limit policies that are likely to be regressive. However, there may be more effective ways of dealing with problems of equity, such as using the tax system to redistribute wealth."⁷⁹

Moreover, RIA seems even to help some of these 'perverse' political forces: "Congressional delegation of rule-making power to agencies subject to Presidential control triggers the problems of bureaucratic and coalitional drifts. The former implies that political principals have to develop rules to make sure that agencies will act in the interest of the principal. The latter arises out of the fact that agencies may over time produce rules that do not reflect the original deal made by political principals and their constituencies for support (i.e., the pressure groups that entered the original deal). In consequence, administrative procedure is used by well-organized interest groups and regulators to exchange information on the demand and the supply of regulation. By requiring agencies to provide information on the costs and benefits of proposed regulation and who is mostly affected by the rules described in the notice

⁷⁷ Ibidem

⁷⁸ Ibidem

⁷⁹ Hahn R., o.c., p. 279

and comment stage of the process, RIA provides an effective fire-alarm for pressure groups. The role played by RIA in the range of tools for the political control of agencies is unique. Instead of controlling agencies ex ante (for example on the budget) or ex-post (for example, by reviewing rules in Court), RIA produces exactly when rules are being formulated.”⁸⁰

The plot thickens: “Another political advantage of RIA is that it ‘facilitates rent-seeking while appearing open and neutral on the surface’. [Some scholars] have concluded that administrative procedures such as RIA are a mechanism to exercise political control over regulatory agencies. RIA procedures ‘enfranchise important constituents in the agency’s decision-making, assuring that agencies are responsive to their interest’. Finally, the ‘most interesting aspect of procedural controls is that they enable political leaders to assure compliance without specifying, or even necessarily knowing, what substantive outcome is most in their interest’. RIA is effective in several ways. First, it allows well-organised interest groups to monitor the agency’s decision-making process [...]. Second, it imposes delay, affording ample time for politicians to intervene before an agency can present them with a ‘fait accompli’. Third, by ‘stacking the deck’ to benefit the political interests represented in the coalition supporting the principal, procedures allow regulation produced by executive agencies to satisfy the preference of the most powerful constituencies.”⁸¹

This brings Hahn back to our original conclusion that the lack of regulatory quality needs to be understood in a misallocation between demand and supply of regulation: “More effective regulatory evaluation can be thought of as affecting both the supply and demand for regulation. On the supply side, such evaluation has the potential to yield alternatives that increase the net benefits of achieving regulatory goals. On the demand side, regulatory evaluation can change the demand for regulation by making the positive and negative effects of regulation more widely known. In some instances, one might expect that politicians and bureaucrats would see little value in changing demand in that way. Ultimately, economic analysis cannot be expected to drive the political process. After all, many politicians tend to be more concerned with distributional issues than with overall benefits and costs. Without significant support from key elected officials, I suspect that most attempts at introducing or strengthening the role of economic analysis of regulation will have only a modest effect. Nonetheless, in a world where regulatory impacts are frequently measures in the billions of dollars, margins matter.”⁸² So, the question becomes how to direct the political process of lawmaking and legislation in the right direction. Who or what can force politicians the walk the path of regulatory quality? That is where courts have to intervene. But that raises a new question, to be addressed in the following chapter: how must courts do that?

Chapter I.D. The judicial review of ‘regulatory quality’

I.D.1. New developments

In the US, always somewhat a frontrunner in these matters, judicial review of regulatory quality is done quite intensively, as Renda observes: “The courts have played a special role in the process of learning by clarifying principles of risk regulation and by developing jurisprudence on risk regulation. Although RIA and risk regulation are not the same, it is important to stress that the progress made in relation to issues such as uncertainty, the level of protection, risk-risk analysis, and proportionality in risk reduction have been made because of judicial review and the very active role played by courts. The courts have in fact used the review of agencies’ rule to make the principles and practices of risk assessment more explicit and more rigorous. In the past decades, federal courts have clearly moved from an initial

⁸⁰ Radaelli C., o.c., p. 6-7

⁸¹ Ibidem

⁸² Hahn R., o.c., p. 291

reluctance to accept cost-benefit analysis by federal agencies to an increased recognition of the need for sound ex ante assessment of costs and benefits aimed at motivating the need to regulate and the choice of the regulatory option.”⁸³

He continues his observation of the judicial review in the US: “The relevance and desirability of the judicial review of agency rulemaking has been subject to a lively debate in the United States, not limited to benefit-cost analysis, but, even more hectically, in the domain of risk assessment and the use of scientific evidence in support of regulatory decisions. According to some authors, the prospect of transparency (through notice and comment) and subsequent review in court transforms the RIA document into a double-edged sword for regulatory agencies, as the document itself may serve as a basis for litigation at a later stage. Likewise, other authors have expressed doubts on the courts’ ability to scrutinize technical documents such as RIAs, and pointed at an overly strict interpretation of cost-benefit requirements as having caused suboptimal regulatory decisions and too strict standards in regulation in a number of occasions.”⁸⁴ This fierce discussion brings us to the question what lessons we can draw from these experiences?

According to the current legal theory of EU law, the proportionality principle, when used in the judicial review of regulatory quality, means that the legal instruments, EU or national, which try to attain a certain policy goal, are suitable hereto and do not go further than strictly necessary. This review implies a control to some degree of the relationship between goal and means, but also on its impact: effectiveness and efficiency. This review remains marginal or limited because this review has developed out of the rather vague principle of reasonability where justification and carefulness play an important role. According to the jurisprudence of the European Court of Justice (ECJ), the EU legislator has wide discretionary power when political, economic or social choices are needed or when complex assessments need to be made. When there is a wide margin of discretionary policy appreciation, then the judicial review is limited to evaluating whether the measure is clearly unsuitable. A European measure is only then illegitimate when it is clearly unsuitable in attaining the defined policy goal. But even in these cases the EU legislator has to objectify its choices, make them ‘reasonable’. Moreover, when assessing the burdens caused by the different policy measures, the legislator has to analyse whether the chosen measure justifies in the light of the aimed policy goals considerable negative economic consequences for particular market players.

Now, in the Vodafone ruling⁸⁵ to be discussed later on in this chapter, the EC J has for the first time ever explicitly referred to an impact assessment, performed by the European Commission as a proof of careful and reasonable lawmaking, more particularly the analysis of several policy options and their impacts. This was repeating in another recent ruling⁸⁶, so it seems to have become a settled case-law. Besides this, the Court has once again confirmed⁸⁷ the marginality or limitedness of the review of proportionality by ruling that the illegitimacy of a particular EU action needs to be assessed by its facts and by the legal situation during the time of the action, and, more in particular, that this assessment can not depend on considerations who are linked afterwards with the efficacy of the action. The assessment of the legislator can only be disapproved when the facts or data on the time of the decision are clearly incorrect. From the proportionality principle follows, according to the ECJ⁸⁸, that a suitable measure has to pursue the realization of the goal on a effective, coherent and systematic way. The Court has also repeated its case-law⁸⁹ that the principle of legal certainty as a cornerstone of European legal order, requires that a EU measure is clear and specific, in

⁸³ Renda A., o.c. p. 37

⁸⁴ Renda A., o.c., p. 38

⁸⁵ ECJ, 8 June 2010, *Vodafone e.a.*, C-58/08, *Jur.* 2010, I-4999, r.o. 55

⁸⁶ ECJ, 12 May 2011, *Luxemburg/Parlement en Raad*, C-176/09, r.o. 65

⁸⁷ ECJ, 28 July 2011, *Agrana Zucker*, C-309/10, r.o. 45

⁸⁸ ECJ, 16 December 2010, *Josemans*, C-137/09, r.o. 70

order to enable the legal subjects to know their rights and duties undoubtedly and to base their expectations on it.

Finally, the court also reiterated its jurisprudence on the interest and scope of the justification principle. The justification principle, as required by article 196 of the Treaty on the Functioning of the European Union (TFEU), demands that the reasoning of the EU institution that introduced the measure must be clear and unambiguous in order to enable the stakeholders to know the justification grounds of the taken measure in order to enable the court to perform its reviewing function, though it is not necessary that all relevant data, factually or legally, are specified. When reviewing the compliance of this motivation duty, attention not only needs to be paid to the wording of the measure, but also to the context in which it is taken, and to the whole of legal rules which the measure is part of. When the essence of the goal pursued by the institution is revealed by the contested measure, then, according to the Court, it is pointless to expect a specific justification for each technical choice. The Court⁹⁰ also ruled that the justification requirement of article 296 of the TFEU is an essential formal requirement that needs to be distinguished from the issue of the validity of the justification which deals with material legitimacy of the contested measure. Most of the time, the ECJ⁹¹ discovers enough elements in the explanatory part of the measure to refute the criticism on the justification principle.

Let us now turn back to the famous Vodafone ruling and analyse the exact wording of the results of the judicial review of regulatory quality in which the Impact Assessment allegedly played a vital role. The, for this study relevant, judicial reasoning went as follows:

“51. According to settled case-law, the principle of proportionality is one of the general principles of Community law and requires that measures implemented through Community law provisions be appropriate for attaining the legitimate objectives pursued by the legislation at issue and must not go beyond what is necessary to achieve them (Joined Cases C-453/03, C-11/04, C-12/04 and C-194/04 *ABNA and Others* [2005] ECR I-10423, paragraph 68 and the case-law cited).

52. With regard to judicial review of compliance with those conditions the Court has accepted that in the exercise of the powers conferred on it, the Community legislature must be allowed a broad discretion in areas in which its action involves political, economic and social choices and in which it is called upon to undertake complex assessments and evaluations. Thus the criterion to be applied is not whether a measure adopted in such an area was the only or the best possible measure, since its legality can be affected only if the measure is manifestly inappropriate having regard to the objective which the competent institution is seeking to pursue (see, to that effect, Case C-189/01 *Jippes and Others* [2001] ECR I-5689, paragraphs 82 and 83; *British American Tobacco (Investments) and Imperial Tobacco*, paragraph 123; *Alliance for Natural Health and Others*, paragraph 52; and Case C-558/07 *S.P.C.M. and Others* [2009] ECR I-0000, paragraph 42).

53. However, even though it has a broad discretion, the Community legislature must base its choice on objective criteria. Furthermore, in assessing the burdens associated with various possible measures, it must examine whether objectives pursued by the measure chosen are such as to justify even substantial negative economic consequences for certain operators (see, to that effect, Joined Cases C-96/03 and C-97/03 *Tempelman and van Schaijk* [2005] ECR I-1895, paragraph 48; Case C-86/03 *Greece v Commission* [2005] ECR I-10979, paragraph 96; and Case C-504/04 *Agrarproduktion Staebelow* [2006] ECR I-679, paragraph 37).”

This reasoning brought the ECJ to the following conclusion in the particular case:

⁸⁹ ECJ, 8 July 2010, *Afton Chemical/Secretary of State for transport*, C-343/09, r.o. 79, ECJ 14 September 2010, *Akzo Nobel Chemicals en Akros Chemicals/Commissie*, C-550/07 P, r.o. 100)

⁹⁰ ECJ, 17 March 2011, *AJD Tuna Ltd*, C-221/09, r.o. 60

⁹¹ ECJ, 28 July 2011, *Agrana Zucker*, C-309/10, r.o. 36; and 17 March 2011, *AJD Tuna Ltd*, C-221/09, r.o. 63-67

“55. In this respect, it must be recalled, first, that, before it drafted the proposal for the regulation, the Commission carried out an exhaustive study, the result of which is summarised in the impact assessment mentioned in paragraph 5 of this judgment. It follows that the Commission examined various options including, inter alia, the option of regulating retail charges only, or wholesale charges only, or both, and that it assessed the economic impact of those various types of regulation and the effects of different charging structures.”

The question now becomes: what to make from this apparently crucial ruling? Is there a change in the way the ECJ sees the proportionality principles and in the way the ECJ performs the proportionality test? What role will the Impact Assessment Report (IAR) play in this perspective?

1.D.2. An appraisal

Vice-chairman of the ECJ, prof. Lenaerts provides us with the first answers: “*Vodafone* is an interesting example that shows how the ECJ applies the principle of proportionality in a procedural fashion. Instead of second-guessing the merits of the substantive choices made by the EU legislator, the ECJ preferred to make sure that lawmakers had done their work properly: the EU legislator had to show before the ECJ that it had taken into consideration all the relevant interests at stake. In so doing, the ECJ stressed the importance of the preparatory study carried out by the Commission, in which the latter institution showed that it had examined different regulatory options and assessed their economic, social and environmental impact, before deciding to impose a price ceiling in the retail roaming market. In the Commission’s own words, the impact assessment is ‘the process of systematic analysis of the likely impacts of intervention by public authorities. It is as such an integral part of the process of designing policy proposals and making decision-makers and the public aware of the likely impacts’. Indeed, in its judgment, the ECJ referred to the findings set out in the IAR on six occasions and to those laid down in the explanatory memorandum on five. As Brenncke notes, it seems that ‘[the] more the [ECJ] requires from the Commission in procedural terms, [...] the more it will alleviate the marginal judicial review of the substantive issues which a “manifestly inappropriate” standard entails.’⁹²

This view is shared by the legal scholar Alemanno as he writes: “To sum up, EU courts seem increasingly willing to consider the EU institutions to be under a duty to act in a consistent and non-arbitrary manner, which entails a duty to apply the rules that it has established for itself. However, as our analysis has shown, while it is true that a self-binding effect for self-imposed rules seems to have gradually found its way within the EU legal order, it remains to be seen to what extent, and on which basis, this case law may be extended to the Impact Assessment (IA) soft law documents. On this point, it might be observed that, unlike most of the self-imposed rules that were at issue in the abovementioned judgments (a memorandum from the Director-General, an internal guide, etc), the IA Guidelines appear to enjoy a greater institutional and political weight. In particular, the IA guidelines find their origins in resolutions and policy statements of the European Council and contribute to the implementation of express Commission policies. Moreover, as shown above, the implementation of the IA system by the Commission services is susceptible to the administratively enforced within the Commission hierarchy via the quality control mechanisms.”⁹³

More specifically, “[a]lthough the Courts have been able to assess – at least until now – the compliance with these principles without necessitating any analysis at the drafting stage of the

⁹² Lenaerts K., *The European Court of Justice and Process-oriented Review*, Research Paper in Law, European Legal Studies, 01/2012, Brugge, p. 7

⁹³ Alemanno A., ‘A Meeting of Minds on Impact Assessment’ (2011) 17 *European Public Law* 485, p. 10-11

proposal, the current practice of carrying out an IA for all major Commission initiatives might lead the Courts to refer to such previous evaluations before reaching their conclusions. This might occur as a result of the Courts acting *sua sponte* or upon request of the parties. For instance, when assessing whether a final measure falls within the competence of the EU, the Court might look at how this question has previously been assessed by the Commission services at the drafting stage of the proposal. Indeed, the IA guidelines clearly state that ‘once identified the problem and its causes, you [Commission official] still need to verify if the EU has the right to take action (principle or conferral) and if it is better placed than the Member States to tackle the problem (subsidiarity principle)’ [IA guidelines, p. 21]. Likewise, as the IA guidelines require the Commission to establish ‘which policy options and delivery mechanisms are most likely to achieve’ the objectives pursued by the underlying initiative, the Court might take this previous evaluation into account when determining whether the final measure complies with the principle of proportionality. It is argued that the increasing availability of ready-made material prepared at the pre-legislative phase might shape, by providing to it some more bite, the intensity of the judicial scrutiny.⁹⁴

Let us continue with the appraisal of Lenaerts: “The application of ‘procedural proportionality’ in *Vodafone* is, in my view, a positive development in the case-law of the ECJ on the sensitive issue of the vertical allocation of powers. It is worth noting that it is the first time ever that the ECJ has expressly relied on the IAR [Impact Assessment Report] when examining the compatibility of an EU policy measure with the principle of proportionality. In order to determine whether the challenged act is *ultra vires* or *intra vires*, the ECJ should not limit its scrutiny to a formal reading of the preamble thereof, but it should undertake a close examination of the explanatory memorandum and, notably, of the IAR. I concur with Craig in that the elaboration of an IAR does not exempt the ECJ from checking whether the conditions for having recourse to Article 114 TFEU, as a legal basis, have been met. However, he correctly posits that the IAR does provide a helpful framework within which to address ‘competence creep’ or ‘competence anxiety’ concerns. In his view, ‘if the justificatory reasoning to this effect in the IAR is wanting, then the ECJ should invalidate the relevant instrument, and thereby signal to the political institutions that the precepts in the Treaty are to be taken seriously’.⁹⁵ So, there still needs to be an analysis of the content of the IA to see whether the analysis results of the IAR make sense or not. The question can be raised if this is also the case when other political sensitive issues like the proportionality of the impact of regulations on property rights.

Lenaerts continues: “In summary, *Vodafone* shows how ex ante legislative assessment and ex post judicial review may contribute to a more rational law-making. Most importantly, *Vodafone* demonstrates that, by basing its reasoning on the IAR, the ECJ gives important incentives to the EU legislator to investigate alternative mechanisms and policies seriously.”⁹⁶ But he immediately raises an important warning: “Moreover, judicial reliance on the IAR is not always possible. For example, it is difficult to take into consideration the IAR where the Council and the European Parliament have made amendments to the Commission’s proposal. The fact that the Council and the European Parliament departed from the IAR does not mean, however, that the contested measure is contrary to the principle of proportionality. Otherwise, if the Council and the European Parliament were bound by the IAR, the principle of institutional balance would be called into question. Yet, Alemanno notes that, in such a case, the Council and the European Parliament are compelled, by virtue of the 2003 IIA on Better Lawmaking, to carry out their own IAR on the proposed amendments to the Commission’s

⁹⁴ Alemanno A., o.c., p.13-14

⁹⁵ Lenaerts K., o.c., p. 7-8

⁹⁶ Lenaerts K., o.c., p. 9

proposal. In *Afton Chemical*, the ECJ took a more limited approach: it just required those amendments to be based on scientific data, but it did not require an IAR.⁹⁷

Alemanno goes one step further by asking the following questions: “Should the court be willing to consider an IA to determine whether a challenged EU act is in breach of the principles of subsidiarity, conferral or that of proportionality, one may wonder what kind of role these previous evaluations may play within such a final judicial determination. Could IA offer a useful aid to EU Courts in carrying out judicial review? What if the Commission has not performed these preliminary analyses? May the Court consider that in the absence of these preliminary assessments it is not possible to determine whether the challenged regulation conforms to the abovementioned principles? Would the Court be entitled to verify whether there exists a rational relationship between the final ruling on an act and previous examinations, such as an IA? Or is it required to do so? Some of these questions have been raised for the first time in *Spain v Council*, where the ECJ, after highlighting the lack of an IA by the EU legislature, found a breach of the general principle of proportionality and annulled the regulation contested by Spain.”⁹⁸

This ‘Spain ruling’ was actually the stepping stone for the Vodafone ruling, or put differently, with the Vodafone ruling, the ECJ has built further on the Spain ruling by making the answers to the above raised questions more and more positive. Alemanno observes about the ‘Spain ruling’: “As has been observed, ‘this is new to the jurisprudence of the ECJ’. This seems to be true for at least two reasons. First of all, this assertion shows in an unprecedented way a clear shift towards greater judicial review of basic facts by the EU courts. Even if this trend was initiated by a line of well-known judgments, these have been judgments in the areas of merger control and risk regulation, and not in the area of the CAP [Common Agriculture Policy]. Given the high technicality of these fields, it is tempting to link the ECJ’s greater scrutiny to a wider move towards evidence-based policy-making in the EU. Second, although it would be unreasonable to interpret this judgment as imposing a general obligation on the EU legislature to perform an IA, the court is nonetheless pointing out that, when engaging in a (more intensive) judicial scrutiny of the basic facts which underlie an EU act, as triggered by a claim of a breach of the principle of proportionality, it might turn out to be useful have an IA at one’s disposal. Indeed, what if an IA had been carried out by the Commission service in that case? According to the *a contrario* reasoning of the judgment, it seems that this would have enabled the court to assess whether the EU institutions ‘had exceeded the limits of what is appropriate and necessary in order to attain the legitimate objectives pursued by the legislation into question’. In other words, an IA would have facilitated the court’s task of determining whether the challenged measure ‘was manifestly appropriate’. What better way for the EU legislature to prove ‘the taking into consideration of all the relevant factors and circumstances of the situation the act was intended to regulate’ than by producing an IA before the ECJ?”⁹⁹

With respect to the new development, triggered by the Vodafone-case, Alemanno claims: “Vodafone confirms that, as predicted in *tempore non suspecto*, the role that IA is progressively expected to play within the process of judicial review is not only that of an ‘aid to the legislator’ but also that of an ‘aid to the court’. As illustrated above, it seems that IA may provide already today ‘analytical support’ within the judicial examination of general principles of EU law, such as subsidiarity, conferral and proportionality. Indeed, to the extent that IAs contain a pre-legality check of the proposed legislation vis-à-vis those principles, it is likely that EU Courts, when called upon to review the legality of adopted legislation, will refer to the IA analysis. EU Courts may do so *sua sponte*, or under the pressure of the parties

⁹⁷ Lenaerts K., o.c., p. 9

⁹⁸ Alemanno A., o.c., p. 15

⁹⁹ Alemanno A., o.c., p. 16-17

to the dispute. In any event, as exemplified by the *Vodafone* judgement, it is clear that the general availability and growing dissemination of IA reports will facilitate their encounters with ex post judicial review.”¹⁰⁰

Alemanno summarizes: “It is clear by now, especially in the light of the most recent case law, that the possibility that pre-draft activities, performed under IA, might play some role as the ex post judicial review stage deserves careful analysis. IA, not being part of the legislative procedure, is not mandatory for any EU institution and, as a result, the Commission, like any other institution, is supposed neither to perform nor to stick to IA results during the decision-making process. Yet the existence of ready-made ‘pre-legality checks’ contained in IA reports may offer interested parties a solid background upon which to rely when questioning the legality of a EU act. IA is not only emerging as an ‘aid to the parties’ in dispute, but also as a potential ‘aid to court’. Indeed, as exemplified by *Vodafone*, an ex ante ‘legality check’ of general principles of EU law, such as proportionality, contained in an IA report may provide ‘analytical support’ during their ex post judicial scrutiny. There is indeed no reason, regardless of the IA’s legal status, why EU Courts, called upon to review the legality of a EU act, would not glance at its IA report and employ it as a useful benchmark. This – as shown in *Afton* – is not to say that the Courts will necessarily find illegal those EU acts which have departed from the IA results – especially due to the margin of manoeuvre recognised to both the Council and the Parliaments in the legislative process, but to suggest that Courts may instinctively, or under the parties’ request, look at the IA results during their legality review. The IA report, being part of the *travaux préparatoires* of virtually all EU legislative acts adopted since 2002, may indeed disclose useful information on the ‘pre-legality check’ and intentions of the initiator of the legislation under review.”¹⁰¹

He concludes: “In essence, more information available from the making of the initial rule means more evidence accessible when checking its legality. This may not only facilitate the task of the reviewing Court but also lead it, as shown by the example of the proportionality principle illustrated above, to shape the nature of the principle under review, thus increasing the stringency of its legality control. It has been demonstrated that, as a result of the abovementioned encounters, there might indeed be an interesting circular dynamic between ex ante analysis of proposed legislation and ex post analysis of adopted regulation. The threat of having its acts struck down, or merely used as a reference, by the EU Courts when called upon to review their legality, may provide an incentive to the Commission and the EU co-legislators to carefully subject the original proposal, as well as their amendments, to it to rigorous impact assessment. Curiously enough, this will not necessarily happen as a result of a ‘juridification’ of the IA process as such within EU decision-making. Rather, as illustrated above, this is more likely to occur through a subtler phenomenon of cross-fertilisation between ex ante scrutiny and ex post control methodologies. In other words, impact assessment is set to contribute to an unprecedented meeting of minds between the EU legislator and the EU judiciary. When this will occur? It is happening right now, but – as for any judicial epiphany – the results of these encounters will materialise steadily and silently.”¹⁰²

Chapter I.E. Preliminary conclusions

In the previous chapters, we have made the following observations:

- the increase of regulatory pressures on society, coming from the EU;

¹⁰⁰ Alemanno A., o.c., p. 18

¹⁰¹ Alemanno A., o.c., p. 19

¹⁰² Ibidem

- not so much market failures, as government failures and public choice drivers are at the origin of this rise;
- the development and application of the Impact Assessment methodology in the EU has not proven to be a success in reducing the regulatory pressures, due to the intrinsic complexity of the cost-benefit-analysis and to the distorting political environment in which the Impact Assessment has to operate;
- the judicial review of the regulatory quality undergoes some new (and promising) developments, including a better use of the Impact Assessment.

The question now becomes whether the problem of the increasing regulatory state is hereby solved. Unfortunately, the answer is probably negative, because the two proposals to strengthening the judicial review by better using the Impact Assessment are inherently flawed. These two proposals are:

- the insights of the legal theory of ‘structuralism’ in order to improve judicial review,
- the improvement of the IA by introducing lessons of behavioural law and economics.

I.E.1. The need for another and better judicial review

Let us start by explaining what the legal theory of ‘structuralism’ stands for: “Structuralism is a theory of U.S. constitutional adjudication according to which courts should seek to improve the decision-making process of the political branches of government so as to render it more democratic. In words of John Hart Ely, courts should exercise their judicial-review powers as a ‘representation-reinforcing’ mechanism. Structuralism advocates that courts must eliminate the elements of the political decision-making process that are at odds with the structure set out by the authors of the U.S. Constitution. The advantage of this approach, U.S. scholars pose it, lies in the fact that it does not require courts to second-guess the policy decisions adopted by the political branches of government. Instead, they limit themselves to enforcing the constitutional structure within which those decisions must be adopted.”¹⁰³ The question can be raised if and to what extent the structure of the constitution can be separated from its content.

Lenaerts seems to follow this structuralist approach: “Without claiming that structuralism should be embraced by the ECJ as the leading theory of judicial review, the purpose of my contribution is to explore how recent case-law reveals that the ECJ has also striven to develop guiding principles which aim to improve the way in which the political institutions of the EU adopt their decisions. In those cases, the ECJ decided not to second-guess the appropriateness of the policy choices made by the EU legislator. Instead, it preferred to examine whether, in reaching an outcome, the EU political institutions had followed the procedural steps mandated by the authors of the Treaties. Stated simply, I argue that judicial deference in relation to ‘substantive outcomes’ has been counterbalanced by a strict ‘process review’.”¹⁰⁴

To that effect, he discussed “three recent rulings of the ECJ, delivered after the entry into force of the Treaty of Lisbon, where an EU policy measure was challenged indirectly, i.e. via the preliminary reference procedure, namely *Vodafone*, *Volker und Markus Schecke* and *Test-Achats*. Whilst in the former case the ECJ rules that the questions raised by the referring court disclosed no factor of such a kind as to affect the validity of the challenged act, in the two latter cases the challenged provisions of an EU act were declared invalid.”¹⁰⁵ Let us bear in mind this difference in outcome between the first and the two following rules, because to my opinion, this difference in outcome comes to no surprise.

¹⁰³ Lenaerts K., o.c., p. 2

¹⁰⁴ Lenaerts K., o.c., p. 2-3

¹⁰⁵ Lenaerts K., o.c., p. 2-3

Lenaerts summarizes the three rulings: “*Vodafone*, *Volker und Markus Schecke* and *Test-Achats* are three recent judgments which were delivered after the entry into force of the Treaty of Lisbon. To some extent, these judgments reveal that, when examining the validity of EU policy measures, the ECJ is not reluctant to follow an approach that focuses on improving the decision-making process of the EU institutions, rather than on second-guessing their substantive findings. As *Vodafone* shows, ‘process review’ is an interesting way of making sure that, in areas where the EU legislator enjoys broad discretion, the latter does not commit abuses. ‘Process review’ increases judicial scrutiny over the decision-making process of the EU institutions. However, it prevents the ECJ from intruding into the realm of politics. Moreover, by inviting the political institutions of the EU to enhance the rationalization of their decision-making process, the ECJ enforces the structure put in place by the authors of the Treaties. Whilst ‘process review’ shows due deference to the expertise and higher institutional capacities of policy makers, it may be the only way of judicially enforcing principles that have a clear political nature, such as the principle of subsidiarity.”¹⁰⁶

So, what Lenaerts is actually saying is that the courts can only check the ‘carefulness’ in which the EU policymakers have taken their policy decision. More particularly, they have to show that they have taken into account the opinions of all relevant stakeholders, for example by making an Impact Assessment Report in which these opinions figure and are dealt with. How valuable in se this seems to be – at least better some judicial review of regulatory quality than no review at all – this approach might prove to be unsatisfactory in reducing regulatory pressures for two reasons.

First, as already earlier mentioned, Radaelli points at the fact that the IA enforces the activities of stakeholders, hereby increasing the actions of pressure groups. A ‘participatory’ approach to regulatory quality may eventually lead to more lobbying and rent seeking, leading to a deteriorating regulatory quality. Second, as Lenaerts acknowledges: “Of course, this theory of constitutional adjudication, like all theories, has its shortcomings. For example, detractors of structuralism argue that it is difficult, if not impossible, to draw the dividing line between ‘substantive’ and ‘structural’ matters. In particular, they claim that, when identifying the ‘structure’ set out by the authors of the U.S. Constitution, courts necessarily base their determinations not on purely structural principles, but on a set of substantive values, evaluating concepts such as democracy, liberty and equality.”¹⁰⁷

Lenaerts explains the sense of his approach as a piecemeal engineering of judicial review: “Unlike the U.S. academic debate over structuralism, the purpose of my contribution was not to prove the operability (or inoperability) of the ‘substance vs. process’ divide in the context of the EU legal order. Instead, I limited myself to showing the advantages of reviewing the different procedural steps taken by the EU political institutions when adopting an act of general application. In that regard, it seems to me that an increased judicial control of the decision-making process does not imply that judges should take a more pro-active stand whereby the latter replace the substantive choices made by the EU political institutions with their own. Nor should a process-oriented review be equated with judicial surrender. On the contrary, more often than not, courts can contribute to aligning political decisions with the structure set out in the Treaties if they provide incentives to improve the rationality of the decision-making process of policy makers.”¹⁰⁸

But in the end, the question remains whether and to what extent the policy makers have taken into account the opinions of relevant stakeholders in a sufficient manner. Besides, what are ‘relevant’ stakeholders anyway? And because the regulatory pressures can in this approach

¹⁰⁶ Lenaerts K., o.c., p. 15-16

¹⁰⁷ Lenaerts K., o.c., p. 2

¹⁰⁸ Lenaerts K., o.c., p. 16

only be tackled in an indirect or even ‘marginal’ way, another approach in judicial review is needed. This alternative approach seems to be implicitly raised by Lenaerts himself when he writes: “Moreover, ‘process review’ should always precede substantive judicial review in order to allow the ECJ to make use of its ‘passive virtues’ by avoiding unnecessary substantive conflicts with the EU political institutions. In my view, the ECJ is more respectful of the prerogatives of the political institutions of the EU if it rules that, when adopting the contested act, those institutions failed to take into consideration all the relevant interests at stake, than if it questions their policy choices by reference to its own view of the issues involved. This is precisely what the ECJ did in *Volker und Markus Schecke*. Last but not least, *Test-Achats* stresses the importance of consistency. By looking at the contextual aspects of the principle of proportionality, not only is the ECJ enhancing the legitimacy of the EU legislator when the latter imposes limits on fundamental rights, but also its own judicial legitimacy. It shows that the ECJ is ready to declare invalid an EU provision which, in addition to derogating from a fundamental right, gives rise to contradictions with the EU act of which it forms part.”¹⁰⁹

To my opinion, these two cases – in which individual rights came under fire due to new regulatory actions by the EU – provide a better approach than the pure participatory or structuralist approach where the “democratic” processes needs to be enhanced. Because under the guise of a structuralist reasoning, individual rights were actually safeguarded by the ECJ. In essence, the ECJ ruled that the balancing of general interest vs. individual rights was not done properly at the expense of the individual. And just that balancing requires a more substantive approach in which the impact of regulations on individual liberties are tested on the basis of the proportionality principle. A way to improve this kind of proportionality test will be explained in part II of this study.

Besides this, one may ask whether the content of the IAR can be considered as being part of the process review and the ‘structuralist’ approach, and not of an ex post questioning by the court of political decisions, taken by elected officials. In other words, if the content of an IAR proves to be rubbish, then it would violate the rationality, required by the constitutional principles, of the decision-making process of policy makers. There could be one condition attached to it: only when one of the disputing parties raises question about the content of IAR in relation to the constitutionally safeguarded rights and liberties (f.ex. freedom of speech, free entrepreneurship or property rights), can the ECJ annul the disputed legislation based on the insufficient IAR. Only when there is no required IAR at all, or when the IAR proves to be clearly of bad quality (‘marginal testing’), may the ECY *sua sponte* annul the legislation.

I.E.2. The need for a new focus of the IA

In order to realize the aim of using the IAR as part of the necessity, suitability and proportionality tests, the IA methodology must focus on these issues. But that would certainly require a drastic overhaul of the current (‘classic’) IA methodology. As already described earlier on, “[t]he trajectory of Impact Assessment in the European Union is at least tortuous, and a mix of success and failure. The main success lies in the fact that Impact Assessment is – at least partly – changing the way in which bureaucrats in Brussels think about policymaking and the need to motivate the need for policy action, and the form of action that is preferable to others. Only partly, because instances of IAs that fall randomly on the shoulders of unaware officials who have little or no knowledge of economics, as well as cases in which IA is done with a passive box-ticking attitude are still frequent in many DGs.”¹¹⁰

¹⁰⁹ Lenaerts K., o.c., p. 16

¹¹⁰ Renda A., o.c., p. 81

And Renda adds: “The main problem that remains inside the European Commission’s IA system is the lack of a clear focus. Being clear that the EU IA system does not follow the same logic of the US one, and is less geared towards the monetization of all impacts through Kaldor-Hicks cost-benefit analysis, it remains unclear whether the IA document produced by Commission DGs and validated by the Board should abide by any specific methodology or need for quantification. In other words, it is unclear what is the benchmark when the IAB scrutinizes IAs, if not the (still quite generic) IA Guidelines. Perhaps, given the fact that the European Commission has several goals and a generalized lack of policy coordination across different actions, the lack of focus of the IA document simply reflects the lack of policy coherence in Brussels. To be sure, the IA document, far from being a panacea, let alone a piece of highly scientific analysis, is now becoming a sort of synecdoche, a document that contains a summary of all the competing and contrasting interests that surround the formulation and discussion of the policy proposal. This, in turn, makes it very difficult to distinguish the IA document from an explanatory memorandum, even if decorated with tables, some numbers and bit more structure. The fact that the IA document does not adopt a clearly recognizable viewpoint – for example, the result of a quantitative cost-benefit analysis – weakens the process irremediably.”¹¹¹

The answer of the Commission to this problem is to focus on the public governance issue: “The Commission seems to have taken action to solve some of these problems with the Communication on Smart Regulation in the European Union, adopted in October 2010 (COM(2010)543, 11 October 2010). There the Commission announces its intention to ‘close the policy cycle’ by providing for ex post evaluations of existing legislation before any new ex ante IA can be performed. Likewise, the Commission plans to strengthen the ex ante consideration of transposition, implementation, enforcement, and make use of implementation plans at national level. At the same time, the Commission wishes to move beyond the narrow focus of current IAs, which necessarily refers to individual policy initiatives, and engage more in ‘fitness checks’ covering entire policy domains – the first ones were launched in the fields of environment, transport, employment/social policy and industrial policy, but new areas will be identified in 2011. But obviously, the real problem with impact assessment does not lie inside Berlaymont or Charlemagne, but rather inside Justus Lipsius. The fact that the IA document is never updated during the co-decision procedure is a major obstacle to the development of multi-level evidence-based policymaking in the EU. And this is also a major challenge for the Barroso Commission in the years to come.”¹¹²

Renda searches his solution in a relatively new approach in economics, namely behavioural (law and) economics. Economist Jolls explains what this new approach means: “We do not doubt that replacing the simple maximizing model of economics with a more complicated psychological treatment comes at some cost. Solving optimization problems is usually easier than describing actual behaviour. [...] We recapitulate here some of the reasons why we think the enriched model is worth the trouble for those interested in the economic analysis of law.

1. Some of the predictions of the standard model are simply wrong. For example, people can be both more spiteful and more cooperative than traditional analysis predicts, and this matters a great deal to law. It is also important to know that even in a world without transaction costs and wealth effects, the assignment of property rights alters the ultimate allocation of those rights, and that this may be particularly true for certain forms of property-rights assignment (such as court orders). These features of the world matter greatly for making predictions and formulating policy.
2. In other cases, economics makes no predictions (or incorrect predictions of no effect). Prominent in this category are the effects of presentation; since economic theory assumes that choices are invariant to the manner in which a problem is framed, its

¹¹¹ Renda A., o.c., p. 81-82

¹¹² Renda A., o.c., p. 82

falsely predicts that the language of a media account or advertisement has no effect on behaviour, holding the information content constant. In contrast, it is well established that people react differently to potential outcomes depending on whether they are perceived as foregone gains or out-of-pocket costs (losses), and that they are likely to think, mistakenly, that salient events are more common than equally prevalent but more subtle ones. These points bear on the supply of and demand for law, and on the behaviour of agents in their interactions with the legal system.

3. Standard economic theories of the content of law are based on an unduly limited range of potential explanations, namely optimal (or second-best) rules set by judges and rent-seeking legislation by self-interested log-rolling. Behavioural economics offers other sources of potential explanation – most prominently, perceptions of fairness. We [...] show that many laws which are seemingly inefficient and do not benefit powerful interest groups may be explained on grounds of judgments about right and wrong.
4. A behavioural approach to law and economics offers a host of novel prescriptions regarding how to make the legal system work better. Some stem from the improved predictions mentioned in point 2 above. Cognitive difficulties and motivational distortions undermine or alter conventional economic prescriptions about the jury's role, most notably in the context of assessing negligence and making other determinations of fact of law. [...]
5. A behavioural approach to law and economics produces new questions about possible mistakes by private and public actors. On the one hand, it raises serious doubts about the reflexive anti-paternalism of some economic analysis of law. On the other hand, it raises equivalent questions about whether even well-motivated public officials will be able to offer appropriate responses to private mistakes and confusion.¹¹³

But some scholars deeply question the self-proclaimed advantages of behavioural law and economics. Two of them, Douglas Ginsburg and Joshua Wright write: “To date, critiques of behavioural law and economics and its promise of increasing welfare have raised three types of concerns: The behaviourists (1) as we discussed in the previous section, have no way to identify irrational decisions; (2) cannot reliably discern an individual's ‘true preferences’, and (3) fail consistently to account adequately for the social intervention. Each of these concerns raises significant doubt both about the presumption that error-reduction alone increases welfare and about the presumption that error-reduction alone increases welfare and about the potential for behavioural interventions to improve welfare.”¹¹⁴

They explain their first point: “Even if there were robust evidence of irrationality in markets, such evidence would have to be interpreted with care; the challenge would be to distinguish truly irrational behaviour from rationally-made and therefore efficient mistakes. Efficient mistakes occur because rational economic actors economize on both information and transaction costs. In short, not all errors imply irrationality because perfect decision making would be costly. To miss subtle distinctions between rational and irrational decision making will almost certainly lead to erroneous conclusions about legal policy. The data required to distinguish rational mistakes from irrational mistakes, much less to estimate the magnitude of any welfare loss caused by the latter, are significant and may be unavailable. The behavioural law and economics literature nonetheless fails to distinguish between rational and irrational errors, assuming instead that error reduction is always efficient. Where there are information and transaction costs, however, the efficient level of error is not zero.”¹¹⁵

¹¹³ Jolls C. et. al, ‘A Behavioural Approach to Law and Economics’, 50 Stan. L. Rev. 1471, 1998, p 1546-1547

¹¹⁴ Wright J.D. and Ginsburg D.H., ‘Behavioural Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty’, Forthcoming 106 NW.U.L.REV., (published on internet), Version January 6, 2012, p. 41

¹¹⁵ Wright J.D. and Ginsburg D.H., o.c., p. 22-23

Second, “[t]he inevitability of policy errors derives from the insurmountable theoretical and empirical obstacles to identifying any one person’s, let alone the distribution of all persons’, ‘true preferences’. One type of policy error will occur when a behavioural intervention is aimed at seemingly irrational behaviour that is in fact rational for the decision-maker in question. In other words, the social costs of this type of policy error flow from encouraging behaviour the paternalist inaccurately believes will make individuals better off, and concomitantly discouraging acts that satisfy their actual preferences. A second type of policy error will occur when an intervention designed to improve the decision-making of truly irrational economic agents imposes costs, as it inevitably will, upon all those who are not irrational and for whom the same decision is not an error. In this case, it is erroneous beliefs about the distribution of true preferences that leads to the policy error.”¹¹⁶

Third, “[i]n addition to underestimating or ignoring the social cost associated with manipulating choice frames through legal default rules, behaviourists tend to underestimate the costs of implementing proposed policies – an error we term the ‘government intervention bias’. If one believes individuals are predictably irrational and will commit decision making errors, then the relevant policy question is whether society is better off if error-correction is supplied by individuals in markets or by individuals in the government. It is unclear that either bounded rationality or outright irrationality supports a larger role for government as opposed to greater private investment in error correction, but more government is inevitably the policy prescription favoured by the behaviourist agenda. Answering this question requires comparative institutional analysis in order to identify the lower cost source of ‘error-reduction’”¹¹⁷.

In short, “[t]he pro-government position suffers from two underlying problems. First, we question the behavioural economist’s implicit assumption that regulators are rational. As Judge Posner pertinently inquired: ‘Behavioural economists are right to point to the limitations of human cognition but if they have the same cognitive limitations as consumers, should they be designing systems of consumer protection?’ [...] Neither governments nor individuals can make error-free choices. Perhaps, as Thaler says, ‘[e]ven imperfect experts can help us achieve better outcomes’, but the pertinent question is their comparative performance. How costly will government policy errors be if government actors suffer from, say, hyperbolic discounting or status quo bias, or are subject to framing effects? What will be the frequency and magnitude of those errors to the extent they can do so? Can we trust behavioural regulators suffering from confirmation bias reliably to identify the true preferences of individuals, as they would have to do in order to implement successful behavioural policies? [...] The counterintuitive presumption that irrationality among regulators is irrelevant consistently biases cost-benefit analysis in favour of government intervention.

Second, the behaviourists’ government intervention bias depends upon their systematic underestimation of information costs. Behaviourist prescriptions for intervention assume regulators are able to recognize, gather, and process the data required to identify each individual’s ‘true preferences’. Their implicit assumption is that regulators enjoy a comparative advantage over private economic actors in acquiring information. Mario Rizzo and Douglas Glen Whitman describe this obstacle to welfare-increasing behavioural interventions as the “knowledge problem” of behavioral law and economics, derived from Hayek’s well-known critique of central planning. Either of these classes of objections, the default rule fallacy or the government intervention bias, is sufficient to undermine dramatically or to reject altogether the welfare-based case for behavioural law and economics. Even if, however, we assume the behavioural economics research and policy programs can avoid all such problems and would be justified on pure economic welfare grounds, the

¹¹⁶ Wright J.D. and Ginsburg D.H., o.c., p. 28-29

¹¹⁷ Wright J.D. and Ginsburg D.H., o.c., p. 46

behaviourist calculation of the net increase in societal welfare ignores the significant but underappreciated threat to individual liberty posed by government interventions predicated upon behavioural law and economics.¹¹⁸

So, as behavioural law and economics cannot provide the silver bullet solution either, another approach within law and economics is needed to solve the inherent methodological problems of cost-benefit-analysis within the (R)IA. The aim of this new focus for the (R)IA is to improve the judicial review of regulations, i.e. to make the review more substantive by basing it on a scientifically sound and empirically feasible methodology. We develop this proposal in the next part of this study by first looking at its theoretical basis and then by analysing the current situation. Next we develop and explain our new variant of the RIA, followed by a case-study to show its added-value in practice. We finalize by stating the necessary preconditions in order to make this tool function in reality.

PART II. HOW TO FIGHT THIS GROWING EUROPEAN REGULATORY STATE (BETTER)?

Chapter II.A. A better understanding of the main cause of rising regulatory pressures

II.A.1. 'Law, legislation and liberty'

The theoretical foundation of our proposal to focus the (R)IA as a tool for a more substantive judicial review of regulatory quality is to be found in the seminal work of Friedrich von Hayek: *Law, Legislation and Liberty*. Based on earlier work of M. Oakeshott, and of the classical liberals of the Anglo-Saxon Enlightenment tradition, Hayek makes a crucial distinction between 'nomocratic' law and 'telocratic' legislation as respectively the basis of and a potential threat for our individual liberties and constitutional rights; hence the title of his three-part book. Or as Aristotle once said rightfully: 'Law is reason without wishes.' Alas, now we have to observe all too often that regulations are (political and policy) wishes without the reason of the law.

The reasoning behind Hayek's (and Aristotle's) plea for liberty under the "rule of law" is based on the way the economy (and even society as a whole) works: "(i) The basic economic problem is 'a problem of utilization of knowledge which is not given to anyone in its totality'. (ii) The efficient utilization of knowledge, via the market process, requires that individuals be free to pursue their self-interest and capture the consequent rewards, provided they respect the equal rights of others. (iii) This principle of private property requires government by law, because unless property rights are protected by law, individuals will have little incentive to utilize their knowledge efficiently, and to search for what would otherwise be profitable exchange opportunities. (iv) A corollary of this line of reasoning is that if individuals understand their opportunity sets are expanded under the rule of law, they will have an incentive to opt for limited government and a free-enterprise system."¹¹⁹

Or in the words of Hayek himself: "Under the enforcement of universal rules of just conduct, protecting a recognizable private domain of individuals, a spontaneous order of human activities of much greater complexity will form itself than could ever be produced by deliberate arrangement, and in consequence the coercive activities of government should be limited to the enforcement of such rules."¹²⁰ In Hayek's vision, the "rule of law" stands for "a

¹¹⁸ Wright J.D. and Ginsburg D.H., o.c., p. 46

¹¹⁹ Dorn J.A., 'Law and Liberty: A Comparison of Hayek and Bastiat', *The Journal of Libertarian Studies*, Vol V., No. 4, Fall 1981, p. 378

rule concerning what the law ought to be, a meta-legal doctrine or a political ideal”.¹²¹ Unfortunately to Dorn, “Hayek emphasizes the usefulness of the rule of law and freedom in the hope that this will stimulate public support for a constitutional government. However, he recognizes that a proper understanding of his utilitarian justification for freedom requires a sound knowledge of economic principles. The lack of such an understanding, especially ignorance of the principle of spontaneous order, has led to the demise of the rule of law.”¹²²

According to Hayek, the “rule of law” is more particularly based on four principles: “First, the law ought to be general; i.e., it should apply to everyone, including government officials, and be stated as abstract rules that serve to guide individual behaviour. Second, the law ought to be equally applied; Legal privileges should be prohibited. Third, the law ought to be certain; i.e., it should be in the form of long-run rules that are widely recognized and not subject to arbitrary changes. Within such a stable legal framework, individuals will be able to efficiently coordinate their plans, resulting in social order and progress. Finally, the law ought to be ‘just’, that is, it should prevent injustice or the infringement of property rights so that a spontaneous market order can be established.”¹²³ These four characteristics make it possible to differentiate law from legislation.

Hayek phrases it as follows: “We may sum up [...] with the following description of the properties which will of necessity belong to the law as it emerges from the judicial process: it will consist of rules regulating the conduct of persons towards others, applicable to an unknown number of future instances and containing prohibitions delimiting the boundary of the protected domain of each person (or organized group of persons). Every rule of this kind will in intention be perpetual, though subject to revision in the light of better insight into its interaction with other rules. These rules will achieve their intended effect of securing the formation of an abstract order of actions only through their universal application, while their application in the particular instance cannot be said to have a specific purpose distinct from the purpose of the system of rules as a whole. The manner in which this system of rules of just conduct is developed by the systematic application of a negative test of justice and the elimination or modification of such rules as do not satisfy this test.”¹²⁴

Hayek’s concept of justice (and therefore its negative test of justice) is characterised by four elements: “First, justice can be applied meaningfully only to the conditions of individual action, not the results. Values, being subjective, cannot be aggregated in any meaningful fashion; hence, the application of social welfare criteria to public policy is a futile exercise. The real test of justice, according to Hayek, is not conformity to some notion of ‘social (or distributive) justice’, but to the condition of freedom. If exchange is free and property rights well-defined, the results will be mutually beneficial. Second, justice is essentially a negative concept; it refers to the prevention of injustice, not to the attainment of some positive result. Therefore, individuals should only be provided with general ‘rules of just conduct’, within which they can pursue their own interests while respecting the equal rights of others. Third, justice is performed when the law is limited to the protection of property – Locke’s ‘life, liberty and possessions of a man’. [...] If law is limited to protecting the private sphere, Hayek believes individuals will have the greatest opportunity and incentive to utilize their unique knowledge; the market price system will then be free to coordinate economic activity. Finally, justice requires that laws pass the ‘test of universal applicability’. This means that in applying a law to any particular circumstance, it must conform with the existing set of

¹²⁰ Hayek F.A., ‘The Principles of a Liberal Social Order’, in *Studies in Philosophy, Politics and Economics*, Chicago, University of Chicago Press, 1967, p. 162

¹²¹ Hayek F.A., *The Constitution of Liberty*, 1st Gateway ed. Chicago: Henry Regnery Co, 1972, p. 206).

¹²² Dorn J.A., o.c., p. 382

¹²³ Dorn J.A., o.c., p. 377

¹²⁴ Hayek F.A., ‘Rules and Order’, in *Law, Legislation and Liberty*, Routledge, London, 1998., p. 122

rules.”¹²⁵ (p. 377) So, on closer look, Hayek’s vision of justice merges again with generality, equality and certainty characteristics of the law.

This brings Hayek to the minimal state where “all coercive functions of government must be guided by the overruling importance of... the three great negatives: peace, justice and liberty.”¹²⁶ and “If there is to be an efficient adjustment of the different activities in the market, certain minimum requirements must be met; the more important of these are... the prevention of violence and fraud, the protection of property and the enforcement of contracts, and the recognition of equal rights of all individuals to produce in whatever quantities and sell at whatever prices they choose.”¹²⁷ In essence, the law must only provide the basis for justice, not being just in itself.

By the way, this vision is also defended by 19th-century French publicist Bastiat: “Bastiat was primarily interested in providing a moral justification for freedom and, therefore, for limiting the use of force to the protection of person and property. His theory of rights, which specifies the legitimate functions of government, can be summarized as follows.

- (i) Man acts to further his own self-interest, to satisfy his wants, which are subjective. This is his very nature; it is a universal fact that is incontestable and is the starting point for ethical science.
- (ii) To fulfil his nature, man must be free; he must have the right to ‘property’, that is, the right to appropriate the value he produces, the right to exchange it voluntarily for an equivalent value, and the right to bequeath it. These are the sources of legitimate property rights and are merely another expression for liberty. To argue otherwise would be self-contradictory, since it would imply that theft and slavery are right.
- (iii) A corollary of the right of property is the right to defend one’s legitimate property and, hence, to protect one’s life, liberty and justly acquired possessions. This is the only legitimate use of force either by an individual or the state, and is what Bastiat means by ‘universal justice’.”¹²⁸

Bastiat emphasizes that the right to property is ‘prior and superior to the law’. Therefore, ‘it is not property that is a matter of agreement, but law’: “Law is the organization of the natural right to legitimate self-defence; it is the substitution of collective force for individual forces, to act in the sphere in which they have the right to act; to do what they have the right to do; to guarantee security to person, liberty, and property rights, to cause justice to reign over all.”¹²⁹ This brings Bastiat to the conclusion: “In theory, it is enough that the governments have the necessary instrumentality of force at hand for us to know what private services can legitimately be converted into public services. They are those services whose object is the maintenance of liberty, property, and individual rights, the prevention of crime – in a word, all that relates to the public safety. Government also has another function. In all countries there is a certain amount of public property, some goods used collectively by all citizens, like rivers, forests, and highways. On the other hand, there also, unfortunately, debts. It is the government’s duty to administer these active and passive parts of the public domain. Finally, from these two functions stems a third: that of levying the taxes necessary for the efficient administration of public services.”¹³⁰

¹²⁵ Dorn J.A., o.c., p. 377

¹²⁶ Hayek F.A., The principles of a Liberal Social Order, in Studies in Philosophy, Politics and Economics, Chicago, University of Chicago Press, 1967, p. 177

¹²⁷ Hayek F.A., The Constitution of Liberty, 1st Gateway ed. (Chicago: Henry Regnery Co), 1972, p. 229

¹²⁸ Dorn J.A., o.c., p.383

¹²⁹ Bastiat F., The Law, reprinted by Ludwig von Mises Institute, Auburn U.S.A., 2007, p. 52

¹³⁰ Bastiat F., Economic Harmonies, reprinted by Ludwig von Mises Institute, Auburn U.S.A., 2007, p. 459

When we turn back to Hayek's view on the rule of law, we can read about the law as a result of nomocratic policy: "Nomocratic politics focuses on the idea of political institutions as providing a framework of general rules which facilitate the pursuit of private ends, however divergent such ends may be. It is not the function of political institutions to realize some common goal, good or purpose and to galvanize society around the achievement of such a purpose. Rather, nomocratic politics is indifferent to common ends and has an interest in private ends only in so far as they may collide: when X's pursuit of his goal A may prevent Y from pursuing his goal B. Such collision may be avoided by adherence to rules and not by government preferring one private end over another. So, given nomocratic politics, the rule of law is about the essential features of the general rules which govern the terms of political association. The rule of law in this view is therefore not subordinate to another value. There can be no justification for avoiding or suspending the rule of law because of the claimed importance of some other common or collective values."¹³¹

The nature of law can also be described *a contrario* by comparing it with policy-driven regulation: "In the last resort, the difference between the rules of just conduct which emerge from the judicial process, the *nomos* or law of liberty [...], and the rules of organization laid down by authority [...] lies in the fact that the former are derived from the conditions of a spontaneous order which man has not made, while the latter serve the deliberate building of an organization serving specific purposes. The former are discovered either in the sense that they merely articulate already observed practices or in the sense that they are found to be required complements of the already established rules if the order which rests on them is to operate smoothly and efficiently. They would never have been discovered if the existence of a spontaneous order of actions had not set the judges for their peculiar task, and they are therefore rightly considered as something existing independently or a particular human will; while the rules of organization aiming at particular results will be free inventions of the designing mind of the organizer."¹³²

II.A.2. The rise of 'telocratic' regulations at the expense of 'nomocratic law'

Hayek warns that when the rule of law is considered as unpractical and even undesirable, individual liberty will eventually disappear. This kind of thinking has already led to a nearly unlimited power to regulating institutions which are dominated by pressure groups. So, Hayek writes that "today legislatures are no longer so called because they make the laws, but laws are so called because they emanate from legislatures, whatever the form or content of their resolutions."¹³³ This is due to the fact that "[m]uch of the opposition to a system of freedom under general laws arises from the inability to conceive of an effective co-ordination of human activities without deliberate organization by a commanding intelligence. One of the achievements of economic theory has been to explain how such a mutual adjustment of the spontaneous activities of individuals is brought about by the market, provided that there is a known delimitation of the sphere of control of each individual. An understanding of that mechanism of mutual adjustment of individuals forms the most important part of the knowledge that ought to enter into the making of general rules limiting individual action."¹³⁴

According to legal scholar Roger Plant, "[t]he idea of the rule of law lies at the heart of the neo-liberal view of the nature and the role of the state. More than this, however, it is the deep fault line that divides neo-liberalism and social democracy and, for that matter, more radical forms of socialism. On the neo-liberal view, social democracy and socialism are outside the

¹³¹ Plant R., *The Neo-liberal State*, Oxford University Press, p. 6

¹³² Hayek F.A., *Rules and Order*, o.c., p. 122-123

¹³³ Hayek F.A., *The Political Order of a Free People*, vol. 3, *Law, Legislation and Liberty*, Routledge, London, 1998, p. 4

¹³⁴ Hayek F.A., *The Constitution of Liberty*, 1st Gateway ed. (Chicago: Henry Regnery Co, 1972, p. 159

rule of law.”¹³⁵ He explains why: “[S]ocial justice is incompatible with the rule of law because its demands cannot be embodied in general and impartial rules; and rights have to be the rights to non-interference rather than understood in terms of claims to resources because rules against interference can be understood in general terms whereas rights to resources cannot. There is no such thing as a substantive common good for the state to pursue and for the law to embody and thus the political pursuit of something like social justice or a greater sense of solidarity and community lies outside the rule or law.”¹³⁶

Hayek explains this incompatibility between social justice and the rule of law: “[I]t is impossible, not only to replace the spontaneous order by organization and at the same time to utilize as much of the dispersed knowledge of all its members as possible, but also to improve or correct this order by interfering in it by direct commands. Such a combination of spontaneous order and organization it can never be rational to adopt. While it is sensible to supplement the commands determining an organization by subsidiary rules, and to use organizations as elements of a spontaneous order, it can never be advantageous to supplement the rules governing a spontaneous order by isolated and subsidiary commands concerning those activities where the actions are guided by the general rules of conduct. This is the gist of the argument against ‘interference’ or ‘intervention’ in the market order. The reason why such isolated commands requiring specific actions by members of the spontaneous order can never improve but must disrupt that order is that they will refer to a part of a system of interdependent actions determined by information and guided by purposes known only to the several acting persons but not to the directing authority. The spontaneous order arises from each element balancing all the various factors operating on it and by adjusting all its various actions to each other, a balance which will be destroyed if some of the actions are determined by another agency on the basis of different knowledge and in the service of different ends. [...] What the general argument against ‘interference’ thus amounts to is that, although we can endeavour to improve a spontaneous order by revising the general rules on which it rests, and can supplement its results by the efforts of various organizations, we cannot improve the results by specific commands that deprive its members of the possibility of using their knowledge for their purposes. We will have to consider [...] how these two kind of rules have provided the model for two altogether different conceptions of law and how this has brought it about that authors using the same word ‘law’ have in fact been speaking about different things.”¹³⁷ The world is too complex to allow a central planner or organisation to manage all processes and outcomes.

So, the real opponent of nomocracy (or nomocratic law) is telocracy (telocratic legislation): “A telocracy implies the organization of the state and its institutions in pursuit of a single overriding goal or a comprehensive goal within which other values will be given a subordinate place. [...] A telocratic state is an enterprise association galvanizing and mobilizing resources in the pursuit of a dominant end; a nomocratic state is a civil association. The telocratic state or enterprise state has laws which specify what is to be achieved by the state for its citizens; the state as a civil association (a nomocracy) has laws which does not define the ‘what’ of politics – the specific goals to be collectively attained – but rather the ‘how’ of politics – defining the terms and conditions or civil association and the rights and duties which will enable individuals to pursue their multifarious goals.”¹³⁸ In a telocratic state, the laws provide behavioural commands while in a nomocratic state, the law (note the singular) provides the liberty to act as one pleases.

¹³⁵ Plant R., o.c., p. 5

¹³⁶ Plant R. o.c., p. 6-7

¹³⁷ Hayek F.A., Rules and Order, o.c., p. 51

¹³⁸ Plant R., o.c., p. 7

Hayek continues his explanation by grounding his reasoning on the view of the British philosopher Michael Oakeshott: “In a telocracy, in Oakeshott’s view, issues of policy displace the concern with the rule of law. After all, a telocracy is based upon the idea of the achievement of a common or collective end or purpose and the rule of government and politics is to galvanize the member of society and their resources in the pursuit of this common goal – ‘energising and directing a substantive purpose’. The character and scope of law is made subordinate to the achievement of the common purpose as had been said and, as such, policy may be said to be more important than law and indeed [...] such policies cannot be made subject to the rule of law.”¹³⁹ Or, in the words of Oakeshott: “[W]hile in a telocracy, rule of law is not forbidden, it is never something valued on its own account: the only thing valued on its own account is the pursuit and achievement of the chosen end which is a substantive condition of things.”¹⁴⁰ And: “[T]elocracy does not necessarily mean the absence of law. It means only that what may roughly be called ‘the rule of law’ is recognised to have no independent virtue, but to be valuable only in relation to the pursuit of the chosen end.”¹⁴¹

Legal scholar McIntyre explains Oakeshott’s reasoning: “Oakeshott understood teleocracy and nomocracy as the two poles between which modern political theory has oscillated. According to Oakeshott, the teleocratic state is the state conceived as an association of individuals united by their pursuit of a common goal, or telos. The function of the government of the teleocratic state is to manage the pursuit of the purpose. Rules and laws are understood to be merely instrumental to the achievement of the purpose.”¹⁴² To the contrary, “[a]ccording to Oakeshott, the nomocratic state is the state conceived as an association of citizens in terms of general conditions of conduct (laws) subscribed to when making their own choices about purposes and goals. The function of the state is to be the custodian of the conditions of conduct, and thus to protect both the freedom of the individual to pursue particular goals or purposes and to preserve an adequate space for political activity within the larger society.”¹⁴³

According to McIntyre, Oakeshott also added a historic touch to his reasoning: “These two conceptions of the state, nomocracy and teleocracy, were taken from an analogy with the Roman legal concepts of *societas* and *universitas*, and signified two distinct types of association. It is this division which is crucial to understanding his historical account of the modern state. According to Oakeshott, under Roman law, a *societas* was understood to be an association of agents bound by loyalty and conditioned by formal law. This type of association was the result of an agreement to accept certain conditions in the pursuit of individual choices. It was a formal relationship in terms of rules, not a substantial relationship in terms of a common purpose, and the conditions of the relationship were considered to be the rules themselves. [...] Thus, nomocracy is the state understood as an association of individuals under the rule of law. However, according to Oakeshott, the history of the modern European state is not solely the story of the morality of individualism and the nomocratic state. An alternative conception of the state which corresponds to the morality of collectivism emerged in which the state was considered on the analogy of the Roman legal concept of *universitas*. A *universitas* was a mode of association in which the agents were related in pursuit of a substantive goal. This mode was the creation of an already constituted authority and its existence was subjected to periodic review by the constituting authority. A *universitas* was a perpetual association in which membership was voluntary and related to a commitment to pursue the common goal of the association. Rules were instrumental, being considered solely in terms of their usefulness in reaching the goal. There were numerous examples of

¹³⁹ Plant R., o.c., p. 8

¹⁴⁰ Oakeshott, M.J., Lectures in the History of Political Thought, ed. T. Nardin and L. O’Sullivan, Exeter:Imprint Academic, p. 484

¹⁴¹ Oakeshott, M.J., o.c., p. 472

¹⁴² McIntyre K.B., “Orwell’s Despair: Nineteen Eighty-four and the Critique of the Teleocratic State”, presentation at the Annual Meeting of the Kentucky Political Science Association, March 2005, p.2

¹⁴³ McIntyre K.B., o.c., p. 3

such associations in medieval Europe, including guilds, monastic orders, and universities. A state conceived on the analogy of a *universitas* was considered to be group of individuals joined together in the pursuit of a substantive purpose. [...] The laws of such a state, like the individuals composing it, are instrumental to the achievement of the purpose, and the ruler of such a state is considered to be the manager of the purpose.”¹⁴⁴

This distinction between nomocracy and telocracy also has an impact on the adjudication which, in a nomocratic state, “is to be recognised as a procedure in which the meaning of lex is significantly, justifiably, appropriately and durably amplified: significantly, because such a conclusion is not given in the lex; justifiably, because the authority of the amplification must be its relation to lex; appropriately, because the conclusion must resolve a specific contingent uncertainty or dispute about the meaning of lex; and durably because it must be capable of entering the system of lex and becoming available not only to ‘judges’ to be used in resolving future uncertainties or disputes, but also to ‘cives’ to be used in choosing what they shall do.”¹⁴⁵

Plant explains the importance of this distinction for adjudication: “So adjudication in this nomocratic sense is central to the rule of law and its maintenance [...] and its durability. It has to be distinguished clearly from the exercise of discretion which is the other main alternative in linking the general and the particular. This is the major contrast with a telocracy or the state being seen as an enterprise. [...] In an enterprise state, however, alternatives to adjudication reinforce the distance between an enterprise state and the rule of law. This actually follows from the earlier claim that in an enterprise state, questions of policy will dominate – the policy for achieving the aims of the enterprise. Because the enterprise cannot be captured in terms of law and rules but its pursuit involves responding to changing circumstances, there is a need for a decision about the direction of policy to be made. In an enterprise state this is going to be a managerial decision and is also going to involve a very high degree of discretion. Because the enterprise will be much more vulnerable to contingency compared with a set of rules governing the framework of individual choice, managerial decisions will be less durable than adjudicative ones within the rule or law. Unlike a *Rechtsstaat*, governed by the rule or law, a *Wohlfahrtsstaat* cannot build a durable body of decisions or conclusion because the governmental and rule governed management of the enterprise will be subject to constant change just because government is attempting to manage constantly changing circumstances, for example, in health or education.”¹⁴⁶

Moreover, “[s]imilar considerations apply in respect of reasoning and discretion. In a nomocracy adjudication is not to be seen as a discretionary or subjective exercise of will on the part of the judge. There is a text first of all – the law whose relation to the particular case is under judgement and there is a process of reasoning (although not deductive reasoning) which yields the conclusion. This reasoning is open and transparent. It is public and when emanating from a lower court can be subject to challenge and revision. This is not so with the decision-making of the manager of the enterprise state or an arbiter of a dispute about what is produced by the enterprise – the goods of the enterprise. There is no text or body of law for the process of decision-making to be based upon – only previous managerial decisions. In the absence of a text and precedents, reasons will run out and the decision will embody a discretionary and subjective act of will. Nor is there a requirement or even an expectation that a similar decision would be taken in other similar circumstances. Managerial decisions of this sort do not create anything comparable to a corpus of law and a jurisprudence.”¹⁴⁷

¹⁴⁴ McIntyre, o.c., p. 10-12

¹⁴⁵ Oakeshott M.J., *On Human Conduct*, Oxford, The Clarendon Press, p. 138

¹⁴⁶ Plant R., o.c., p. 9

¹⁴⁷ Plant R., o.c., p. 9-10

Plant adds to his explanation: “At the same time there will be disputes about the law and how the law relates to expectations. These disputes have to be resolved by judges. Judges in such circumstances do not act in arbitrary and discretionary ways. Rather they take the existing state of the common law and also the *rationes deciderendi* from previous cases and adjust them to deal with conflicts in expectations. In doing so Hayek argues that the judges find the law or discern the law implicit in the common practices and ways of life of the particular societies in which they exercise their office. In doing so the judge will seek to make clearer and more coherent a set of grown rules which in some respects may have become inchoate and to develop the corpus of common law and to adapt it to new circumstances and to enable it to accommodate new expectations. In a sense, as Hayek points out, the judge acts and operates with principles – but these principles are derived not from some independent moral standpoint like natural law but rather from an understanding of the deepest ideas in the common or grown law, which in turn have made explicit the ideas that are embedded in the habits, norms, and actions of an existing society. Again for Hayek there is a clear contrast between his understanding of the role of the judge in the common law seeking conscientiously to interpret a corpus of law so that while retaining its identity and integrity it is made relevant to changing circumstances and expectations, and the role of the head of an organization concerned with the arbitration and conciliation of interest, and guided by the overall purpose or dominant aim of the organization. In the case of the common law judges, as Hayek argues, they have no overall aim in view beyond the adjudication in the particular case, utilizing both the law as a quasi text and previous decisions. He/she acts in a way that is completely unlike the manager of an organization who conducts himself or herself according to the dominant aim or the organization.”¹⁴⁸ So, in order to improve the adjudication in a democracy (or safeguarding the democratic rights), one needs to understand the actual adjudication (see below).

Chapter II.B. The protection of the ‘democratic’ property law and ‘regulatory takings’

II.B.1. How is it actually done?

The starting point of the protection of property rights at the EU level is to be found in the new EU Charter of Fundamental Rights, in particular art. 17 and its right to property, which states “1. Everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions. No one may be deprived of his or her possessions, except in the public interest and in the cases and under the conditions provided for by law, subject to fair compensation being paid in good time for their loss. The use of property may be regulated by law insofar as is necessary for the general interest.

2. Intellectual property shall be protected.”

This Article is based on Article 1 of the First Protocol to the European Convention on Human Rights (ECHR):

“Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.”

Property right is a fundamental right common to all national constitutions. It has been recognized on numerous occasions by the case-law of the Court of Justice, initially in the Hauer Judgment. The wording has been updated but, in accordance with Article 52(3), the meaning and scope of the right are the same as those of the right guaranteed by the ECHR and the limitations may not exceed those provided for there. Protection of intellectual property,

¹⁴⁸ Plant R., o.c., p. 22

one aspect of the right of property, is explicitly mentioned in paragraph 2 because of its growing importance and Community secondary legislation. Intellectual property covers not only literary and artistic property but also patent and trademark rights associated rights. The guarantees laid down in paragraph 1 shall apply as appropriate to intellectual property.

The Hauer judgment of the ECJ dates already from 13 December 1979, and, according to prof. Lenaerts essentially made two crucial statements about property rights:

1. “The right to property is guaranteed in the Community legal order in accordance with the ideas common to the constitutions of the Member States, which are also reflected in the first Protocol to the European Convention for the Protection of Human Rights. Taking into account the constitutional precepts common to the Member States, consistent legislative practices and Article 1 of the First Protocol to the European Convention for the Protection of Human Rights, the fact that an act of an institution of the Community imposes restrictions on the [particular property rights] cannot be challenged in principle as being incompatible with due observance of the right to property. However, it is necessary that those restrictions should in fact correspond to objectives of general interest pursued by the Community and that, with regard to the aim pursued, they should not constitute a disproportionate and intolerable interference with the rights of the owner, such as to impinge upon the very substance of the right to property.” [...]
2. “In the same way as the right to property, the right of freedom to pursue trade or professional activities, far from constituting an unfettered prerogative, must be viewed in the light of the social function of the activities protected there-under.”¹⁴⁹

Only recently, the protection of fundamental rights has been based on the EU Charter. Though not linked with the protection of property rights, the “*Volker und Markus Schecke* [ruling] is another interesting case where the ECJ decided to carry out a ‘process review’ of the contested EU measure. Just as in *Vodafone*, the ECJ also applied the principle of proportionality in a procedural fashion. However, in contrast to *Vodafone*, the principle of proportionality did not operate as a constitutional tool designed to protect the Member States from an EU ‘competence creep’. In *Volker und Markus Schecke*, the principle of proportionality was relied upon in order to protect individual liberty against arbitrary encroachments by public authorities. *Volker und Markus Schecke* was decided after the entry into force of the Treaty of Lisbon. Consequently, the ECJ had recourse to the Charter not only as an aid to interpretation, but as primary EU law. Hence, the principle of proportionality was applied as defined by Article 52 of the Charter, which states that ‘[s]ubject to the principle of proportionality, limitations may be made only if they are necessary and genuinely meet objectives of general interest recognised by the Union or the need to protect the rights and freedoms of others’.¹⁵⁰

Lenaerts continues his analysis: “In that regard, Article 52(1) of the Charter states that any limitation on the rights thereof must comply with the principle of proportionality. It is thus for the EU institutions and, as the case may be, for the national authorities participating in the implementation of EU law, to verify that any limitation on fundamental rights is suitable to meet the ‘objectives of general interest recognised by the Union’ and ‘the need to protect the rights and freedoms of others’; and that it does not go beyond what is necessary for achieving the legitimate aim pursued. In *Volker und Markus Schecke*, the ECJ found that the publication on a website of the names of the beneficiaries of aid from the EAGF and the EAFRD and of the amounts which they receive from those funds was liable to increase transparency with respect to the use of the agricultural aid concerned. The ECJ reasoned that such display of information reinforced public control of the use to which that money is put and contributes to the best use of public funds. However, regarding the necessity of the publication in question,

¹⁴⁹ Lenaerts K. o.c., p. 2-3

¹⁵⁰ Lenaerts K., o.c., p. 10-11

the ECJ held that it went beyond what was necessary for achieving the legitimate aims pursued, given that neither the Council nor the Commission had ‘sought to strike [the right] balance between the European Union’s interest in guaranteeing the transparency of its acts and ensuring the best use of public funds, on the one hand, and the fundamental rights enshrined in Articles 7 and 8 of the Charter, on the other’. Indeed, derogations and limitations in relation to the protection of personal data must apply only in so far as they are strictly necessary. Thus, the Council and the Commission should have examined whether the legitimate objective pursued by the contested regulations could not be achieved by measures which interfere less with the right of the beneficiaries concerned to respect for their private life in general and the protection of their personal data in particular. Accordingly, the ECJ ruled that Article 44a of Regulation No 1290/2005 and Regulation No 259/2008 were invalid.”¹⁵¹

Finally, Lenaerts draws so conclusions from this ruling: “One may draw three important conclusions from *Volker und Markus Schecke*. First, by declaring invalid Article 44a of Regulation No 1290/2005 and Regulation No 259/2008, the ECJ showed, once again, that it takes the protection of fundamental rights seriously. Second, *Volker und Markus Schecke* also seems to confirm that, in the realm of fundamental rights protection, the standard of review applied by the ECJ is always the same, and does not vary depending on whether the contested measure has been adopted by the EU or by the Member States when they implement EU law. Indeed, the requirements for a limitation on a fundamental right to be compatible with the Charter, laid down in Article 52 thereof, do not distinguish between the EU or the national origin of that limitation. Finally, and most importantly for the purposes of our discussion, in *Volker und Markus Schecke*, the ECJ found that, as opposed to the measure in question in *Vodafone*, neither the Council nor the Commission had done their preparatory work properly. The contested Regulations were deemed incompatible with the principle of proportionality because those two institutions had failed to examine whether there were alternatives which, whilst attaining the objectives pursued, interfered less with the fundamental rights of the beneficiaries concerned. For example, the Council and the Commission should have examined whether limiting the publication of data by name relating to the beneficiaries of the EAGF and the EAFRD to the periods for which they received aid, or the frequency or nature and amount of aid received, was enough. It is true that the ECJ seems to suggest that such a limited publication ‘would protect some of the beneficiaries concerned from interference with their private lives, [whilst providing] citizens with a sufficiently accurate image of the aid granted by the EAGF and the EAFRD to achieve the objectives of that legislation’. However, the findings of ECJ are not conclusive in this respect. It was left for the Council and the Commission, when adopting a new Regulation, to determine whether such limited publication could actually guarantee the objectives they pursue.”¹⁵²

Then, there is another recent ruling from the ECJ which even goes a step further: “In *Vodafone* and in *Volker und Markus Schecke*, the principle of proportionality was applied internally. The question whether the purposes invoked by the EU legislator were genuine did not arise. For example, in *Volker und Markus Schecke*, no one called into question whether the EU legislator was really seeking to enhance transparency with respect to the use of the agricultural aid concerned and to reinforce public control of the use of that money. By contrast, in *Test-Achats*, the ECJ was confronted with that very question. A close reading of that case reveals that the contested EU provision was declared invalid because there was a contradiction between that provision and the objectives pursued by the EU act of which it formed part. The contested EU provision did not comply with the external aspects of the

¹⁵¹ Lenaerts K., o.c., p. 11-12

¹⁵² Lenaerts K., o.c., p. 12-13

principle of proportionality, i.e. it was not consistent.¹⁵³ In other words, the EU could not prove that its policy goals were necessary, so it failed the necessity test.

Lenaerts concludes his analysis of this case: “It follows from the foregoing that, just as when testing the compatibility of a national measure with EU law, the ECJ also verifies whether there are internal inconsistencies as between secondary EU law and hierarchically superior rules of EU law. The ruling of the ECJ suggests that it focuses on the contextual aspects of the proportionality principle, i.e. on the consistency of the EU measure in question. In other words, the principle of proportionality is not applied in an abstract fashion, ‘but as a part of the legal and factual context in which the [contested] measure operates’.”¹⁵⁴

On closer look, it becomes clear that the ECJ case-law on these matters is quite similar to that of the European Court on Human Rights (ECHR). In principle, the legislator is allowed to choose freely the nature of its measures. But in doing so, the proportionality principle requires the legislator to choose measures which do not intrude the convention rights in a disproportionate manner. The case-law of the Court is not clear about the question whether there exists a least onerous test towards the legislator, that would entail that he can only take the measure which attains the policy goal in the least burdensome way. Anyhow, the Court is quite severe when it deals with drastic measures. So, in order to evaluate whether legal interventions are proportional, the Court takes into account the carefulness with which the law was taken. In particular when the legislator has a wide margin of appreciation the Court will not evaluate the content of the legislation, rather it will assess the procedure in which the legislation was developed and approved (ECHR (Grand Chamber), *S.H. and others v. Austria*, 3 November 2011). In this matter the Court rather expresses its concern that the government intervention has to be based on a careful balancing of the involved interests. This balancing must lay at the basis of the legislation itself, at the minimum it must be ensured by the implementation and enforcement of this legislation.

In order to assess the proportionality of a legislation, the Court regularly controls whether the measure is based on numbers and studies. So, the Court does not accept undoubtedly the presuppositions on which the legislation is based, these presuppositions have to be proven. The Court also points out that legislation with a considerable impact on culture, environment and economy must be based on appropriate investigation and study in order to come to a proper balancing of interests. But it is not necessary that extensive and measurable data are available for every aspect of the measure before it is proclaimed; in that case monitoring by a committee of experts may provide a solution. In particular when there are studies claiming the opposite, the legislator has to prove its presuppositions. Not only expert research, but also organizing consultations may be relevant to persuade the Court of the proportionality of a particular legislation. In ethical discussions, consultations may support the legitimacy of the choice of the legislator to give priority to particular rights above others. The most important element is that the legislator has taken knowledge of the diversity of interests at stake. When the legislator has not done extensive research, nor has organised consultations, then it may suffice that the stakeholders have got the opportunity to intervene in the legislative process or to let their opinions know through judicial procedures.

From the previous, it may seem that the lack of extensive studies on which the legislation was taken, may be compensated by monitoring and ex post evaluation. In any case, the Court urges the legislator to perform ex post evaluations in areas which are characterized by a continuous evolution, more in particular by rapid developments in science and law. To the Court, procedural safeguards are helpful in assuring that policy measures are based on careful balancing of interests. For this reason, legislation that gives a considerable margin of

¹⁵³ Lenaerts K., o.c., p. 13

¹⁵⁴ Lenaerts K., o.c., p. 14

appreciation to governments to take individual measures, has also to provide in procedural safeguards when taking these individual measures. At minimum, there has to be an independent court to assess the proportionality of such a measure.

II.B.2. A comparison

When studying the enforcement of private property rights, it is also very instructive to analyze the U.S. constitutional law on this topic. It has been able to develop itself for two centuries now and has already accumulated many relevant experiences and interesting views in this matter. The U.S. constitutional law on property rights has taken its present form through the growing case law of the U.S. Supreme Court, based on the continuous interpretation of the constitutional provisions on private property. The Fifth Amendment, which is also part of the Bill of Rights, is basically focused on protecting the U.S. citizens against the misuses of government power, by requiring the government to follow the proper procedures. It states: “No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except [...]; nor shall any person be subject for the same offense to be twice put in jeopardy of life and limb; nor shall be compelled in any criminal case to be a witness against himself, *nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.*”

Notice the differences between the ‘Due process clause’ in “No person shall [...] be deprived of life, liberty, or property, without due process of law”, and the ‘Takings Clause’ of “nor shall private property be taken for public use, without just compensation”. Each clause is based on its proper government authority: the ‘police power’ for the ‘Due process Clause’ and the ‘power of eminent domain’ for the ‘Takings Clause’. The non partisan think tank Cato Institute explains: “The two public powers that are at issue in the property rights debate are the police power – the power of government to secure rights – and the power of eminent domain – the power to take property for public use upon payment of just compensation, as set forth, by implication, in the Fifth Amendment’s Taking Clause.”¹⁵⁵ The crucial question now is what the exact scope and limitations of those two government powers are, or in other words, what the two clauses precisely mean. As already mentioned, over the last two decades the U.S. Supreme Court has established two legal doctrines which are based on these two clauses: the ‘due process doctrine’ and the ‘takings doctrine’.

Furthermore, the Supreme Court spontaneously developed in 1922 the so-called ‘regulatory takings doctrine’ which is a peculiar mix of the two previously mentioned legal doctrines and deals with regulations that have (almost) the same consequence as physical expropriations: “Until 1922, the Supreme Court recognized only two types of government actions that triggered, under the Takings Clause, a government duty to compensate: formal appropriation of property and physical invasion thereof. In that year, the notion of the ‘regulatory taking’ was born. In *Pennsylvania Coal Co. v. Mahon*, the Court declared that when government regulation of property use goes ‘too far’, a taking may result despite the absence of formal appropriation or physical invasion. Beginning in the late 1970s with the seminal *Penn Central Transportation Co. v. New York City* ruling, the Court initiated an effort, continuing to this day, to articulate a coherent body of rules or guidelines for determining which government regulations require compensation under the Takings Clause and which do not. [...] [T]his jurisprudence is a mix of *per se* rules and balancing tests, with an ample amount of ambiguity thrown in.”¹⁵⁶

The central thesis of the ‘regulatory taking’ doctrine can be summarised as follows:

¹⁵⁵ Cato Institute (Roger Pilon), Cato Handbook for the 108th Congress, Washington D.C., p. 348

¹⁵⁶ Meltz R., ‘Takings Law Today: A Primer for the Perplexed’, Ecology L. Q., Vol. 34: 307, 2007, p. 328

“In contrast to physical acquisitions or intrusions for which compensation is nearly always paid, government regulation of private property generally does not require compensation. Instead, it is viewed as a legitimate exercise of the government’s police power. There is a long-standing question, however, about whether or when a regulation ever becomes so burdensome to a property owner as to require compensation under the takings clause. Regulations that cross this threshold are referred to as ‘regulatory takings’.”¹⁵⁷ But this general principle results in many legal questions and uncertainties, and is therefore subject of many heated debates and sometimes even contradictory rulings of courts: “There has been much more controversy, however, both in the courts and in the academic literature, over government regulations that reduce private property values and to the extent to which these should be compensable. Courts have generally granted the government broad powers to regulate private property in the interest of protecting public welfare. However, some government regulations can become so restrictive as to cause a substantial reduction in the value of private property. When this happens, courts have occasionally found the regulation to be a taking and ordered payment of compensation. The problem is to determine where to set the threshold that separates non-compensable regulations (police power actions) from compensable ones (regulatory takings).”¹⁵⁸

The ‘regulatory takings’ doctrine makes a distinction between regulations which render a private property without any value and regulations which only diminishes the value. The basis for the first kind of expropriation is to be found in an important ruling of the Supreme Court: “In *Lucas v. South Carolina Coastal Council*, the Supreme Court held that government regulation completely eliminating the economic use (and seemingly value, too) of land is a *per se* ‘total taking’¹⁵⁹. Though described by the Court as one of its two categorical takings rules, this rule contains a big exception. [...] [T]here can be no taking when a government restriction eliminates a right the landowner never had.”¹⁶⁰ Things become even more complicated when there is only a diminishing of the (economic) value of the private property. “When the *Lucas* test is inapplicable – that is, when the government interference falls short of completely eliminating use and/or value – courts use the test announced in *Penn Central* [ruling]¹⁶¹. Unlike the categorical *Lucas* rule, the *Penn Central* test involves multifactor balancing; to determine whether a partial regulatory taking has occurred, the court examines the government action for its (1) economic impact on the property owner, (2) degree of interference with the owner’s reasonable investment-backed expectations, and (3) character. These factors are mere guideposts, with (so far) only modest content – as much an analytical framework as a ‘test’. Nor are they necessarily exhaustive. The Court stresses that a partial regulatory taking analysis is not governed by ‘set formula’, but rather is an ‘essentially ad hoc, factual inquiry’. In almost all instances, a court’s invocation of the *Penn Central* test leads to its evaluation of all three factors. However, each factor can, in compelling circumstances, be conclusive that a taking exists, thereby dispensing with the need to examine the other two.”¹⁶²

How logically this evaluation framework of the Supreme Court may appear, the Supreme Court never felt very comfortable about it: “The *Penn Central* test has rarely been invoked successfully in the Supreme Court, except where a special feature of the challenged regulation, such as physical invasion, total taking, or interference with a fundamental property interest, triggered categorical analysis. This situation led some observers during the 1990s to suggest that only the Court’s categorical takings tests – those for total takings and physical

¹⁵⁷ Miceli T.J. and Segerson K., ‘6200 - Takings’, Encyclopedia of Law and Economics, 1999, p. 329

¹⁵⁸ Miceli T.J. and Segerson K., o.c., p. 336

¹⁵⁹ 505 U.S. 1003, 1015, 1029 (1992)

¹⁶⁰ Meltz R., o.c., p. 328

¹⁶¹ 438 U.S. 104 (1978)

¹⁶² Meltz R., o.c., p. 329-330

occupations – retained vitality.”¹⁶³ Moreover, even in case-law of the Supreme Court, things can change quite rapidly: “Within the space of a single month last year, the Supreme Court rendered three property rights decisions in swift succession, shattering a body of property rights jurisprudence that finally has begun to make the protections afforded by the Fifth Amendment’s Just Compensation Clause meaningful. The three decisions, *Lingle v. Chevron U.S.A. Inc.*, *San Remo Hotel v. City and County of San Francisco*, and *Kelo v. City of New London*, were a substantial setback from nearly two decades’ worth of gains in property rights jurisprudence during the Rehnquist era.”¹⁶⁴

Therefore, legal scholar Marzulla has a quite grim view on the legal status of property rights in the US: “Although the numerous protections afforded to private property in the Constitution, especially the Fifth Amendment’s Just Compensation Clause, would appear to place protection of private property on a par with other constitutional rights, throughout much of the nation’s history, the Supreme Court has treated property rights as though they were a ‘poor relation’ to other constitutionally protected rights. Inroads to greater protection for property rights were made in the last two decades; however, each of the three property rights decisions of the last Term had a negative effect on these inroads [...]. Taken as a whole, these three decisions severely restrict the rights of all property owners – from homeowners to business owners – to challenge both regulatory and physical takings of their property, and make it nearly impossible for a property owner to challenge regulatory and physical takings by a state government in federal court.”¹⁶⁵ The main basis appears to be found in the judicial deterrence of the Supreme Court towards political decisions.

Justice Scalia shares this grim view, sees another [ethical] cause, and warns against its consequences: “It leads to the conclusion that economic rights and liberties are qualitatively distinct from, and fundamentally inferior to, other noble human values called civil rights, about which we should be more generous. Unless one is a thoroughgoing materialist, there is some appeal to this. Surely the freedom to dispose of one’s property as one pleases, for example is not as high an aspiration as the freedom to think or write or worship as one’s conscience dictates. On closer analysis, however, it seems to me that the difference between economic freedoms and what are generally called civil rights turns out to be a difference of degree rather than of kind. [...] In any case, in the real world a stark dichotomy between economic freedoms and civil rights does not exist. Human liberties of various types are dependent on one another, and it may well be that the most humble of them is indispensable to the others – the firmament, so to speak, upon which the high spires of the most exalted freedoms ultimately rest. [...] The free market, which presupposes relatively broad economic freedom, has historically been the cradle of broad political freedom, and in modern times the demise of economic freedom has been the grave of political freedom as well.”¹⁶⁶ In this respect, remember the citations of Michael Novak earlier on in this study.

In order to correct this distorted situation, the non-partisan think-tank Cato Institute gives us a legal theory, based on the original point on view of the Founding Fathers. In essence, one first has to realize that “[t]here are two basic ways government can take property: (1) outright, by condemning the property and taking the title; and (2) through regulations that take uses, leaving the title with the owner – so called regulatory takings. In the first case, the title is all-too-often taken not for a public use but for a private use; and rarely is the compensation received by the owner just. In the second case, the owner is often not compensated at all for his losses, and when he is the compensation is again inadequate.”¹⁶⁷ Therefore, Cato realizes:

¹⁶³ Meltz R., o.c., p. 333

¹⁶⁴ Marzulla N.C., ‘Picking up the pieces in the aftermath of the Supreme Court’s 2005 Property rights’ trilogy’, National Legal Center for the Public Interest, Volume 10, n° 6, , p. v

¹⁶⁵ Ibidem

¹⁶⁶ ‘Scalia v. Epstein – Two views on judicial activism’, Cato Institute, Washington DC, January 1985, p. 1-2

¹⁶⁷ Cato Institute, o.c., p. 345-346

“At bottom, then, the Court has yet to develop a comprehensive theory of property rights, much less a comprehensive solution to the problem of government takings. For that, Congress (or the Court) is going to have to turn to first principles, much as the old common-law judges did. The place to begin, then, is not with the public law of the Constitution but with the private law of property.”¹⁶⁸ On closer look, the answer has to be found in the common law.

What does the common law say? “In a nutshell, the basic rights they [the Founding Fathers] have recognized, beyond the rights of acquisition and disposal, are the right of sole dominion – variously described as a right to exclude others, a right against trespass, or a right of quiet enjoyment, which all can exercise equally, at the same time and in the same respect; and the right of active use – at least to the point where such use violates the rights of others to quiet enjoyment. Just where that point is, of course, is often fact dependent – and is the business of courts to decide. But the point to notice, in the modern context, is that the presumption of the common law is on the side of free use. At common law, that is people are not required to obtain a permit before they can use their property – no more than people are required to obtain a permit before they can speak freely. Rather, the burden is upon those who object to a given use to show how it violates a right of theirs. [...] Properly conceived and applied, then, property rights are self-limiting: they constitute a judicially crafted and enforced regulatory scheme in which rights of active use end when they encroach on the property rights of others.”¹⁶⁹ Remember the citations of Bastiat earlier on when he said that the constitution deals with the safeguarding of the property rights, not with the creation of them.

But “if the common law of property defines and protects private rights – the rights of owners with respect to each other –, it also serves as a guide for the proper scope and limits of public law – defining the rights of owners and the public with respect to each other. For public law, at least at the federal level flows from the Constitution; and the Constitution flows from the principles articulated in the Declaration – which reflect, largely, the common law. The justification of public law begins, then, with our rights, as the Declaration makes clear. Government then follows, not to give us rights through positive law, but to recognize and secure the rights we already have. Thus, to be legitimate, government’s powers must be derived from and consistent with those rights.”¹⁷⁰ And, Cato adds: “Its exercise is legitimate, however, only insofar as it is used to secure rights, and only insofar as its use respects the rights of others. Thus, while our rights give rise to the police power, they also limit it. We cannot use the police power for non-police-power purposes. It is a power to secure rights, through restraints or sanctions, not some general power to provide public goods.”¹⁷¹

So, Cato continues, “if the police power is thus limited to securing rights, and the federal government’s police power is far more restricted, then any effort to provide public goods must be accomplished under some other power – under some enumerated power, in the case of the federal government. Yet any such effort will be constrained by the Takings Clause, which requires that any provision of public goods that entails taking private property – whether in whole or in part is irrelevant – must be accompanied by just compensation for the owner of the property. Otherwise, the costs of the benefit to the public would fall entirely on the owner. Not to put too fine a point on it, that would amount to plain theft. Indeed, it was to prohibit that kind of thing that the Founders wrote the Takings Clause in the First place. Thus, the power of eminent domain – which is not enumerated in the Constitution but is implicit in the Takings Clause – is an instrumental power: it is a means through which government, acting under some other power, pursues other ends – building roads, for example, or saving wildlife. [...] As for its justification, the best that can be said for eminent domain is this: the power was

¹⁶⁸ Cato Institute, o.c., p. 346

¹⁶⁹ Cato Institute, o.c., p. 347-348

¹⁷⁰ Cato Institute, o.c., p. 348

¹⁷¹ Cato Institute, o.c., p. 349

ratified by those who were in the original position; and it is ‘Pareto superior’, as economists say, meaning that at least one party, the public, is made better off by its use, as evidenced by its willingness to pay, while no one is made worse off, assuming the owner does indeed receive just compensation.”¹⁷²

To be clear, compensation is only required when the governments acts under its competence of eminent domain: “First, when government acts to secure rights [...], it is acting under its police power and no compensation is due to the owner, whatever his financial losses, because the use prohibited or ‘taken’ was wrong to begin with. [...] Thus, the question is not whether value was taken by a regulation but whether a right was taken. Proper uses of the police power take no rights. To the contrary, they protect rights. Second, when government acts not to secure rights, but to provide the public with some good [...] and in doing so prohibits or ‘takes’ some otherwise legitimate use, then it is acting, in part, under the eminent domain power and it does have to compensate the owner for any financial losses the may suffer. The principle here is quite simple: the public has to pay for the good it wants, just like any private person would have to. Bad enough that the public can take what it wants by condemnation; at least it should pay rather than ask the owner to bear the full cost of its appetite. It is here, of course, that modern regulatory takings abuses are most common as governments at all levels try to provide the public with all manner of amenities, especially environmental amenities, ‘off budget’”¹⁷³ In other words, if a government wants to have a social policy through regulations and not with taxes, the results stay the same because the government still has to pay for it.

Now Cato turns back to the regulatory takings issue: “Starting from these first principles, then, we can derive principled answers to the regulatory takings question. And we can see in the process, there is no difference in principle between an ‘ordinary’ taking and a regulatory taking, between taking full title and taking only uses – a distinction that government supporters repeatedly urge, claiming that the Takings Clause requires compensation only for ‘full’ takings. [...] In fact, in every area of property law except regulatory takings, we recognize that property is a ‘bundle of sticks’, any one of which can be bought, sold, rented, bequeathed, what have you. Yet takings law has clung to the idea that only if the entire bundle is taken, does government have to pay compensation. That view enables government to extinguish nearly all uses through regulation – and hence to regulate nearly all value out of property – yet escape the compensation requirement because the all-but-empty title remains with the owner. And it would allow a government to take 90 percent of the value in year one, then come back a year later and take title for a dime on the dollar. Not only is that wrong, it is unconstitutional. It cannot be what the Takings Clause stands for. The principle, rather, is that property is indeed a bundle of sticks: take one of those sticks and you take something that belongs to the owner. The only question then is how much this loss is worth.”¹⁷⁴

And so, “when the Court in 1992 crafted what is in effect a 100 percent rule, whereby owners are entitled to compensation only if regulations restrict uses to a point where all value is lost, it went on the matter backwards. It measured the loss to determine whether there was a taking. As a matter of first principle, the Court should first have determined whether there is a taking, then measured the loss. It should first have asked whether otherwise legitimate uses were prohibited by the regulation. That addresses the principle of the matter. It then remains simply to measure the loss in value and hence the compensation that is due. The place to start, in short, is with the first stick, not the last dollar.”¹⁷⁵

¹⁷² Cato Institute, o.c., p. 349-350

¹⁷³ Cato Institute, o.c., p. 350

¹⁷⁴ Cato Institute, o.c., p. 351

¹⁷⁵ Cato Institute, o.c., p. 351

Cato Institute concludes with a political message: “The application of such principles is often fact dependent, as noted earlier, and so is best done by courts. But until courts develop a more principled and systematic approach to takings, it should fall to Congress to draw at least the broad outlines of the matter, both as a guide for the courts and as a start toward getting its own house in order. In this last connection, however, the first thing Congress should do is recognize candidly that the problem of regulatory takings begins with regulation. Doubtless the Founders did not think to specify that regulatory takings are takings too, and thus are subject to the Just Compensation Clause, because they did not imagine the modern regulatory state: they did not envision our obsession with regulating every conceivable human activity and our insistence that such activity – residential, business, what have you – take place only after a grant of official permission. [...] Many of those regulations are legitimate, of course, especially if they are aimed, pre-emptively, at securing genuine rights. But many more are aimed at providing some citizens with benefits at the expense of other citizens. They take rights from some to benefit others. At the federal level, such transfers are not likely to find authorization under any enumerated power. But even if constitutionally authorized, they need to be undertaken in conformity with the Takings Clause.”¹⁷⁶

The question now becomes how to put this legal theory into practice. A good start could be the already mentioned Supreme Court ruling *Penn Central*. Unfortunately, “[n]otwithstanding the Court’s recent reinvigoration of the *Penn Central* test, it has shed little light on the content of the test’s three factors, or on how to balance them. Each factor raises ‘vexing subsidiary questions’. Commentators on property owner and government sides alike have harshly criticized the lack of definition in the factors, particularly now that the Court has had more than a quarter-century to illuminate them.”¹⁷⁷ The three factors of the *Penn Central* test fall apart in elements which, in their turn, also require clarification.

Especially the last criterion, the nature of the government intervention, is the most unclear and elastic factor of the *Penn Central* test. From the start, the Court interpreted it by claiming that the actual expropriation “may more readily be found when the interference with property can be characterized as a physical invasion by government [...] than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good.”¹⁷⁸ Meltz correctly analyses: “From time to time, courts assert that regulatory takings analysis (outside the total taking context) includes a balancing of the public interest advanced by the government measure against the burden on the property owner. [...] The pendulum may swing yet again, however, if *Lingle* [ruling], as noted, is construed to minimize the importance of the government interest being furthered. Balancing, when it occurs at all, tends to characterize the government purpose only in broad terms. For example, courts consistently refuse to find regulatory (but not physical) takings based on government countermeasures in the broad realms of war, emergencies, and national security. Public health and safety purposes may also be generically cited by courts in tilting against a taking. By contrast, courts tend not to closely dissect the value of the government action in the particular circumstance before them and rank that value within the larger category.”¹⁷⁹

So, though the *Penn Central* test seemed to lift a tip of the curtain in finding a true analysis in dealing with regulatory takings, its reasoning behind it got stuck in the legal mud. The degree in which the ‘nature’ of a government intervention can be equalled with a physical invasion by government seems to be inspired by the need to find a link with the initial view on expropriation (the physical taking), but in practice only complicates the matters further. Unfortunately, it seems to have brought the Supreme Court to abandon this line of thinking

¹⁷⁶ Cato Institute, o.c., p. 352-353

¹⁷⁷ Meltz R., o.c., p. 333

¹⁷⁸ *Penn Central*, 438 U.S. at 124

¹⁷⁹ Meltz R., o.c., p. 342-343

and to go back again to its initial point of judicial deference towards government policies. A better option would be to view the third part of the Penn Central test, on the nature of the government intervention, as a question whether the government intervention is in essence ‘telocratic’ or ‘nomocratic’ by nature, as described earlier. Once this has been done, one may answer the questions, as described in the first and second part of the Penn Central test, on how much damage to property or interference in the property use the government intervention causes. This analysis is needed to know how much compensation is needed in the case of a telocratic regulation (no compensation is needed in the case of nomocratic legislation). But in order to answer these questions, which cannot be done in abstracto but has to be based on the particular facts and situation, an analysis tool has to be developed to be used in court. This is what we are planning to do in the following chapter.

Finally, the same reasoning may also be applied in the European situation. Remember the wording in the ECHR and the EU Charter where the use of property may be regulated in accordance with or insofar as is necessary for the general interest. Now, if we accept that this exception should be considered in a restricted way (as should be the case with every exception on a general principle), then this ‘use’ must be seen a ‘nomocratic’ manner, or stemming from the ‘police power’ of government. So, the use of property can only be regulated when this regulation is needed to make transactions and interaction within the society possible, or to facilitate these interactions. If the “use”, instead, is considered in a ‘telocratic’ way, flowing from the ‘eminent domain’ authority of government, then that may erode the whole concept of property, as the government will gradually detect an ever growing list of policy goals and public needs for which individual properties must be used.

Chapter II.C. A new focus for the (R)IA

In order to develop a new focus for or variant of the (R)IA, we need to work both on the format and on the substance or content of this new (R)IA. Or, put metaphorically, on the bones (the skeleton) and on the flesh (the muscles and veins) of the RIA-methodology. Let us start by redefining the economic analysis that the renewed RIA has to undertake.

II.C.1. A new focus for law and economics: the Austrian and neo-institutional approaches

As already mentioned earlier, “[d]uring the eighties and nineties, the first generation of law and economics has been severely attacked concerning methodological, philosophical as well as legal aspects of the theory. As compared to the mid-seventies and early eighties, when the ‘paradigm of classical law and economics had just reached full bloom’, the movement has now split into quite different lines of inquiry, each exploring new and different research directions. Economic analysis of law has evolved a lot in recent years, and its actual insights reach far beyond the theses professed by the efficiency approach initiated three decades ago among others by Richard Posner. Law and economics has become a vast and heterogeneous discipline, reflecting several traditions, sometimes competing and sometimes complementary, including the Chicago School of Law and Economics, the New Haven School, Public Choice theory, Institutional Law and Economics, New Institutional Law and Economics and Austrian Law and Economics.”¹⁸⁰

Let us begin with the Austrian School: “[The Austrian School of Law and Economics] has in particular provided a decisive traditional, efficiency-oriented law and economics, by showing that social [economic] efficiency is an empty and meaningless concept. Austrian economists underlined the impossibility for a social planner (legislator or judge) to centralize the knowledge that would be required in order to promote an allocation of resources which

¹⁸⁰ Krecké E., ‘The Nihilism of the economic analysis of law’, publicized on <http://mises.org/journals/scholar/Krecké.pdf>, p. 1

corresponds to a social optimum. Consequently, the problem of dispersed and subjective knowledge seriously compromises the idea of an efficient law making in the sense of a balancing of social costs and benefits. Today, even the strongest bastions of neoclassical economic theory of law seem to take into account the insights of the Austrian School. Contemporary economic analysis of law furthermore experiences the influence of recently emerging postmodern legal theories whose revolutionary impact on American legal philosophy in general can hardly be exaggerated. [...] Parallel to the explosion of the literature in these different fields, there seems to be a sort of implosion of neoclassical economic analysis of law, the so-called Chicago Law and Economics, which so far has been the dominant school of thought within the law and economics movement. This implosion may be explained by the fact that a growing part of the discipline seems to become more and more self-critical, to the point of questioning central assumptions like the efficiency of the legal system.¹⁸¹ The notions of explosion and implosion may be somewhat exaggerated, but it is clear that the still dominant neoclassical school is mitigated by the ‘Austrian’ insights

When we go into more detail, we first have to detect the fundamentals of neo-classical economics, in order to alter it: “[T]here can be no genuine progress of the theory without a radical inversion of the values and the logic upon which it is built. In this respect, the critical approaches of efficiency theory, as far as they provide a more realistic and critical vision of the law, may help neoclassical economic analysis of law to get out of the deadlock to which their methodology eventually leads it. In particular Austrian economics, which is built on an entirely different methodology than neoclassical theory, can offer important insights.”¹⁸²

Economists Kasper and Streit work this out in more detail: “Neoclassical economics has become the dominant mode of economic analysis in the twentieth century. It centres on the conditions of economic equilibrium and is normally based on the simplifying assumptions:

- that economic agents have ‘perfect knowledge’;
- that people pursue their purposes rationally and maximise some target variable subject to budget constraints;
- that it is possible to describe representative households, producer-investors and governments;
- that business transactions, for example in markets, are frictionless and cost-free; and
- that the individual preferences of the members of society can somehow be expressed in a social welfare function.

In contradistinction to evolutionary economics, the analysis typically begins with an equilibrium – understood as a situation in which people’s plans and expectations are mutually compatible – that is disturbed by one isolated event, and then shows to what new equilibrium the system moves (comparative static analysis, assuming all other things to be equal: the famous ceteris paribus clause of economic textbooks). It is often assumed that policy makers are able to design a line of rational action which achieves their objectives. These assumptions facilitate the formulation of mathematical models and econometric analyses. And in turn these suggest that economic policy should be conducted in terms of predetermined goals and instruments, pulling deftly at ‘the levers of the economy’.”¹⁸³

Kasper and Streit add: “At the level of practical economic policy, standard neoclassical mainstream economics repeatedly failed in recent years to explain or predict real-world phenomena, because it excluded from its models institutions and the reasons for their existence. The poverty of standard economics became clear, for example, in explaining the growth process. Policy advice in developing countries was often misplaced, because many economic advisers made the habitual assumption that institutions do not matter. In reality,

¹⁸¹ Krecké E., o.c., p. 1-2

¹⁸² Krecké E., o.c., p. 2

¹⁸³ Kasper W. and Streit M., o.c., p. 35-36

many imported concepts foundered because the institutions in developing countries differed greatly from those in the developed countries and because indigenous institutions had to be adapted if certain policy concepts were to work. The institutional framework in which modern production and trade can flourish can therefore frequently not be taken for granted.”¹⁸⁴ This line of thinking has been re-affirmed by the new best-seller of Acemoglu and Robinson, “Why nations fail”.

Now, what makes the Austrian thinking on law and economics so different from the neo-classical model? “In the Austrian tradition, indeed, the law, as it emerges from the legal practice, is viewed as a social institution, a form of spontaneous order that comes out as individuals (legislators, judges, lawyers, market participants) interact in their attempts to develop adapted responses to the problems posed by their ignorance and uncertainty. In this perspective, a society’s legal system has no existence apart from the subjective preferences and the conduct of the individuals who constitute that society. The evolution of such a system is open-ended and unpredictable. In Hayek’s vision, it is not clear what the original purpose of law was, because the law emerges as the result of ‘human action, not human design’. Legal rules and institutions are determined as part of an ongoing social learning and adaptation process which operates through trial and error, experimentation, imitation and compromise. As a consequence, the law, as Austrians perceive it, could not be perfectly efficient, fair or whatever. In contrast to standard law and economics, the Austrian understanding of law openly accounts for the imperfections in the legal system without considering the presence of such flaws as a misfortune. What is important to this perspective is to understand how the law works, evolves and adapts to change, what makes it intelligible and to what it serves in society, in other words its modus operandi. In this line of thinking, no ultimate value is advanced whose achievement becomes a central goal for legal institutions.”¹⁸⁵

There is one exception: “The only implicit value that matters in Austrian reasoning is individual freedom of action. Here probably lies one of the major differences of logic between neoclassical law and economics and the Austrian vision of legal process. While the first sees in law a means to act upon individuals (the purpose being to direct and control human behaviour in order to make it compatible with the desired social goal), in the latter, law is understood as a means that allows individuals to act for themselves, according their own objectives and means. In the Austrian perspective, law seeks to ‘maximize individual freedom of action’, the only constraint being imposed by individual responsibility not to harm others.”¹⁸⁶ So, the law in Austrian sense should be in essence nomocratic in nature, while the law in the neoclassical sense is somewhat purpose-driven, because of its efficiency aim.

In the words of Kasper and Streit: “The Austrian contribution placed the analysis of rules into the context of limited human knowledge, methodological individualism – the insight that only people act, never abstract collectives, such as nations, races, or social classes – and subjectivism – the insight that only individuals are able to read the world subjectively and therefore differ in their ability to understand the world and in their value judgements. From this it follows that interpersonal differences have to be respected and cannot be easily aggregated into collective goals. [...] Institutional economics is also based on the conception of the economy as a complex, evolving system. The notion of equilibrium as a durable state or as a normatively desirable condition is alien to this approach. Instead of such ahistorical notions, economic life is seen as being on a path of gradual evolution, with some elements appearing, others disappearing, as people select what suits their diverse purposes.”¹⁸⁷

¹⁸⁴ Kasper W. and Streit M., o.c., p. 4

¹⁸⁵ Krecké E., o.c., p. 13

¹⁸⁶ Krecké E., o.c., p. 14

¹⁸⁷ Kasper W. and Streit M., o.c., p. 34-35

The economist Krecké concludes: “Even though, through such assertions, efficiency considerations implicitly emerge in the Austrian framework, efficiency is far from being a central value in this context. It furthermore has a very different meaning than in traditional economics. In the rare cases Austrian economics formulate normative judgments of a policy or an institution, their assessment is not based upon the efficiency characteristics of the resource allocation resulting from that policy or institution, but rather upon estimations as to the relative impacts of policy alternatives on the degree of freedom accorded to individuals to implement the plans they have made. Efficiency is not viewed as a goal, but rather as an attribute of a legal system that seeks to promote the creation in society of an order of actions on the part of individuals. [E]fficiency is a purely relative concept. Efficiency per se does not mean anything. There are no intrinsic values, all values are necessarily adherent.”¹⁸⁸

The Austrian School has some similarities with the neo-institutional economics and provides an other alternative to the neo-classical thinking: “The central tenet of this discipline [of (neo-)institutional economics] is that a modern economy is a complex, evolving system whose effectiveness in meeting diverse and changing human purposes depends on rules which constrain possibly opportunistic human behaviour (we call these rules ‘institutions’). Institutions protect individual spheres of freedom, help to avoid or mitigate conflicts, and enhance the division of labour and knowledge, thereby promoting prosperity. Indeed, the rules that govern human interaction are so decisive for economic growth that the very survival and prosperity of humankind, whose numbers are bound to increase for some time yet, depend on the right institutions and the fundamental human values that underpin them.”¹⁸⁹

As with the Austrian School, “[neo-]institutional economics differs greatly from modern neoclassical economics, which is based on narrow assumptions about rationality and knowledge and which implicitly assumes the institutions as given. Institutional economics has important connections with jurisprudence, politics, sociology, anthropology, history, organisation science, management and moral philosophy. [...] The realisation that institutions matter has spread rapidly over the past 20 years. [...] The trailblazers of this approach were writers such as Friedrich von Hayek and others writing in the Austrian tradition, Ronald Coase, who alerted economists to the consequences of transaction costs, James Buchanan and others of the ‘public choice’ school, economic historians such as Douglass North, who discovered the importance of institutions by analysing past economic development, and economists such as William Vickery who showed the consequences of people having limited, asymmetric knowledge.”¹⁹⁰

More specifically, “[a]nother way of making the same fundamental point is to draw attention to the high and rising share of coordination costs in the total cost of producing and distributing the national product in modern economies. A large part of the service sector – which now accounts for no less than 66 per cent of the total OECD’s economic product – is concerned with facilitating transactions and organising human interaction. The ‘coordination sector’ of the modern economy is necessary to facilitate the growing division of labour and knowledge on which our living standard is based. [...] A similar blind spot is the source of failure in diagnosing why the heavily administered welfare economies are experiencing an economic slowdown, high unemployment, growing distrust and widespread voter cynicism. The gradual erosion and decay of essential institutions – such as reliable property rights, self-responsibility and the rule of law – in interest-group dominated democracies has often gone unnoticed. Ways to turn back the clock were not readily discovered because institutional change was not part of what most economists analyse.”¹⁹¹

¹⁸⁸ Krecké E., o.c., p. 14

¹⁸⁹ Kasper W. and Streit M., o.c., p. X

¹⁹⁰ Kasper W. and Streit M., o.c., p. X-XI

¹⁹¹ Kasper W. and Streit M., o.c., p. 5

The crucial importance of property rights for economic growth goes as follows: “Growth is driven by entrepreneurs using knowledge in a deepening division of labour (specialisation). This is only possible with appropriate ‘rules of the game’ to govern human interaction. Appropriate institutional arrangements are needed to provide a framework to human cooperation in markets and organisations and to make such cooperation reasonably predictable and reliable. A coordinative framework is, for example, provided by cultural conventions, a shared ethical system and formal legal and regulatory stipulations [...]. The result is an understanding of the growth process that ties the macroeconomic analysis to the micro-economics of structural change and the microeconomic foundations of motivation and institutional constraints, in other words, that relate economic growth to sociological factors such as preferences and value systems.”¹⁹²

It is important to notice here that “[i]nstitutions are defined here as man-made rules which constrain possibly arbitrary and opportunistic behaviour in human interaction. Institutions are shared in a community and are always enforced by some sort of sanction. Institutions without sanctions are useless. Only if sanctions apply, will institutions make the actions of individuals more predictable. Rules with sanctions channel human actions in reasonably predictable paths, creating a degree of order. If various related rules are consistent with each other, this facilitates the confident cooperation between people, so that they can take good advantage of the division of labour and human creativity. [...] The general presumption is that institutions have a great impact on how people attain their economic and other objectives and that people normally prefer institutions which enhance their freedom of choice and economic wellbeing. But institutions will not always serve these ends. Certain types of rules may have deleterious consequences for general material welfare, freedom and other human values, and a decay of the rule system can lead to economic and social decline. It is therefore necessary to analyse the content and effect of institutions on choice and prosperity as part of institutional economics.”¹⁹³

So, “[t]he key function of institutions is to facilitate order: a systematic, non-random and therefore comprehensible pattern of actions and events. Where there is social chaos, social interaction is excessively costly, confidence and cooperation disintegrate. The division of labour, which is the major source of economic well-being, is not possible. [...] Order inspires trust and confidence, as well as reducing the costs of coordination. When order prevails, people are able to make predictions, are then better able to cooperate with others and feel confident to risk innovative experiments of their own. People then can more easily find the information they need about specialists with whom they can cooperate and to guess what such cooperation is likely to cost and return. More useful knowledge will be used and discovered as a consequence.”¹⁹⁴ In this respect, institutions need to be nomocratic in the sense that they facilitate voluntary inter- and transactions, and a nomocracy can only exist when institutions provide this stability and predictability.

As a reminder of the difference with the neo-classical approach, one needs to acknowledge that “[c]onventional neoclassical economics has pushed the knowledge problem aside by making the simplifying assumption of ‘perfect knowledge’. Many economic textbooks make this assumption on page 1 so that they can begin with logical deductions from this and other premises. What this implies in practice is that the preferences of millions of people for trillions of goods, services and satisfactions are known, as well as all the resources on earth and the billions of relevant production techniques. Then it is possible to reduce economics to simply computing how known resources are transformed by known technologies to meet the

¹⁹² Kasper W. and Streit M., o.c., p. 20

¹⁹³ Kasper W. and Streit M., o.c., p. 28

¹⁹⁴ Kasper W. and Streit M., o.c., p. 28-29

pre-existing, known preferences of ‘economic man’. The elegant mental map of reality, the neoclassical model that one obtains, reduces the most essential questions of economics to a poor, overly abstract construct of the mind. Because of the birth defect of ‘perfect knowledge’, neoclassical theory often has little relevance to real human existence, which is a constant attempt to know more and test old knowledge. [...] Our approach to institutional economics is not based on the assumption of ‘perfect knowledge’. Rather, the lack of knowledge – ignorance – is taken as part and parcel of human existence. It cannot be eliminated, because it is constitutional. But [...] the lack of knowledge can be eased by appropriate institutional arrangements which can be guided individual decision makers through a complex and uncertain world and can help us to economise on the need to know. This approach may make economic analysis more cumbersome and less elegant, but, we trust, more relevant to understanding reality and more convincing to the practitioners in business and public policy.”¹⁹⁵

When we apply these insights on the topic of property rights, we start our analysis by acknowledging that: “[t]he defining characteristic of private property rights is that owners have the right to exclude others from possession, active uses and benefits derived from using that property and that they are fully responsible for all the costs of property use. Excludability is the precondition of the autonomy of the owner and of the incentive mechanism through which private property rights work. Only when others can be excluded from sharing the benefits and costs that property rights assign can these benefits and costs be ‘internalised’, that is, have complete and direct impact on the expectations and decisions of the property owner. Then, the valuations of others about the uses of the property are signalled completely to the owner and they will have the incentive to engage in property uses that others welcome through their ‘dollar votes’. These signals and incentives are distorted when some of the benefits, or some of the costs, do not impact on the property owner. [...] Excludability is thus important in ensuring that private property uses are steered to reflect what others want. The incentive works through the profit-loss signal, and the provision of goods and services are wanted by others are but a by-product of that incentive.”¹⁹⁶ Property rights and its characteristic of excludability facilitate the necessary calculation process of the value of one’s property.

It is important to acknowledge that “[e]xternalities arise when there are knowledge problems, when it is impossible or too costly to measure all costs and benefits and put them to the account of their originators. Thus, it is too costly to identify who benefits from a neighbour’s vaccination and how much that benefit is valued by the neighbour. The effects of factory emissions on others may also be costly or impossible to measure and evaluate. If, however, the technique of measurement changes – for example, due to improved computer and communications technology – then excludability may become feasible and externalities may be converted into internalised benefits and costs.”¹⁹⁷

Because, “[w]hen costs and benefits can, by and large, be internalised, property owners will be guided voluntarily by expected profits and losses in bilateral contracts, competing with each other in doing so, as a matter of their private choice. When major externalities exist, coordination can become much more complicated as multilateral agreements have to be negotiated. The give and take is then less clear than in bilateral exchange and the incentives to act are often fuzzy. Normally, externalities require multilateral political arrangements by which property uses and returns are established, often a complex and opaque matter. As a consequence, public or collective choice is often less effective in satisfying citizens’ diverse and changing goals. [...] In reality, excludability is often imperfect and externalities are

¹⁹⁵ Kasper W. and Streit M., o.c., p. 52

¹⁹⁶ Kasper W. and Streit M., o.c., p. 177-178

¹⁹⁷ Kasper W. and Streit M., o.c., p. 178

widespread. Many external effects are simply tolerated and do not hinder voluntary exchange activities. Often, there may be private settlements to deal with externalities; for example, when my activity adversely affects my neighbour and we agree that I compensate him. In other cases, the externalities of private action are dealt with by government agencies, for example by regulations or transfers.”¹⁹⁸

On the other hand, “[e]xcluding others from using one’s property without authorisation causes costs to the owner. Such unauthorised uses may, for example, be theft or squatting on land. To prevent this, people incur the expenses of locks, fences, share and land-title registries and information-protection systems in computers. We call these costs exclusion costs. High exclusion costs lower the value of property. To a considerable extent, they depend on institutional arrangements, beginning with the underlying standard of ethics that is shared in the community. If private property is spontaneously respected, private exclusion costs will be low and property values will be relatively high. If a community has invented a low-cost system of enforcing property rights, this will also benefit property values. Thus, an effective land-title registry raises land values. Where property law is enforced by collective action (legislation, police, judiciary), a large part of the exclusion costs are borne collectively, but this has considerable cost advantages for property owners over individual protection (scale economies). We know that different institutional systems have great influence on exclusion costs and property values. It is not surprising that property owners, when they have a chance, shift their property to an environment where it is highly valued and that they are prepared to contribute taxes to provide protective collective action.”¹⁹⁹

Though *nomocratic* legislation may be needed to lower exclusion costs, *telocratic* regulation may be detrimental for the value of property: “When private property rights are collectivised, private, bilateral contracting is replaced by political choice, and the problems of private choice are replaced by the problems of public choice.”²⁰⁰ Moreover, “[s]hared respect for private property may also decline when wealth distribution becomes extremely lop-sided. [...] Certain vulnerable forms of property holding, even if potentially very useful, may then be avoided altogether. However, if collective action tries to redistribute property rights by selective interventions, this may raise exclusion costs further. If, for example, the borrower or tenant of a property is accorded increasing rights at the expense of the property owner, or the police and courts cease to prosecute violations of property rights, people’s motivation to acquire property by making efforts on behalf of others, will wane. Similar consequences must be expected when the penalties for failure to repay loans are not enforced: credit breaks down and scarce capital is poorly utilised. Deleterious consequences for economic growth can then be observed. These losses are often underrated because they materialise slowly, reflecting the typically slow adjustment of the internal institutions of society. It therefore takes time to break down the private property system.”²⁰¹

Now, what could be the added value of (clearly written) legislation? What are the specific characteristics of ‘nomocratic’ legislation or good institutions? “Given the cognitive and other limitations of human nature, institutions, to be effective, have to be easily knowable. To that end they should be simple and certain, and sanctions for violation should be clearly communicated and understood. This is not the case when rules proliferate and are purpose-specific, rather than abstract, or when rule systems become inherently contradictory. Nor should institutions discriminate between different people, giving some groups preferences

¹⁹⁸ Kasper W. and Streit M., o.c., p. 178-179

¹⁹⁹ Kasper W. and Streit M., o.c., p. 187

²⁰⁰ Kasper W. and Streit M., o.c., p. 185

²⁰¹ Kasper W. and Streit M., o.c., p. 188

over others. Then, institutions are less likely to be obeyed and serve their function of economising on knowledge search less well.²⁰²

Besides this, “[a] related basic criterion for effective institutions brings in an intertemporal dimension: rules that change all the time are harder to know and are less effective in ordering people’s action. Rules should therefore be stable, conforming with the age-old, conservative saying that ‘old laws are good laws’. The advantage of stable institutions is that people have adjusted to old institutions to the best of their advantage and have acquired a practice of following them almost instinctively. Stability therefore reduces enforcement costs, improves reliability and hence facilitates human interaction. The flipside of stability is the danger of institutional rigidity, even in the face of changing circumstances. Hence there must be some scope for adjustment. When rules are open, that is, when they apply to an indeterminate number of future cases, rigidity is less of a problem than if the rules are case-specific. But even open rules may require adaptation if new circumstances evolve.”²⁰³

Also, “[w]e must underscore an important difference between proscriptive and prescriptive institutions. Those who prescribe actions – who give instructions and direct – will normally need much more specific knowledge than those who only rule out certain types of action. The one who prescribes the behaviour of others must be aware of the means and capabilities of the actors as well as of possible conditions for and consequences of the prescribed action. Those who rule out certain types of behaviour only need to know that certain actions are undesirable, but they leave the specific detail of the action and the evaluation of consequences to the actor. Actors thus have more freedom when guided by prohibitions of the type ‘thou shall not’.”²⁰⁴

And let us not forget with regard to the spontaneous compliance and enforcement that “[s]ocial norms are relevant to the understanding of several aspects of the formulation and implementation of legal rules. First, if we accept that social norms exert a constraint on individual preferences and choice, the natural consequence will be that the same legal rule may exert a different impact depending on the type of social context in which the decision to comply will be formulated. A similar effect was defined, though in a different stream of academic literature, as the ‘compliance trap’. [...] When this is the case, any attempt to enforce the law in a formalistic way is doomed a failure, unless the policymaker can promote the ‘moral’ content of the law in a way that directly changes the social norms behind it. The strength of social norms can be so decisive that in some environments social norms definitely trump legal rules whenever a conflict arises. When social norms diverge from the scope and content of a legal rule, the latter’s effectiveness can be significantly undermined. Enforcers will find it often inappropriate to apply the rule to a full extent, as they themselves do not share the policymaker’s judgment on the morality of the law; recipients will face a collective action problem in deciding to comply: since, when everyone complies, the cost of compliance is lower and the benefit of compliance is greater, the individual act of complying creates positives externalities that are never fully internalized until others behave similarly.”²⁰⁵

All these factors and views need to be integrated in the (R)IA methodology, so it becomes possible to take them into account when developing legislation. That is what we will try to do in the next chapter.

II.C.2. The ‘nomocratic’ (R)IA

²⁰² Kasper W. and Streit M., o.c., p. 96

²⁰³ Kasper W. and Streit M., o.c., p. 96

²⁰⁴ Kasper W. and Streit M., o.c., p. 97

²⁰⁵ Renda A., o.c., p. 115-116

An interesting view on the nature and necessity of rules has been developed in 2000 by Oliver Williamson with his taxonomy of the four distinct stages of and in the social institutions: “Level (1) mostly consists of social institutions, including social norms, which lay the foundations for their layers and deeply affect their working. Level (2) contains formal legal rules that realize the allocation of entitlements, including most notably property. The next level (3) deals with the transfer of entitlements and governance of economic relationships, including in particular contract law. Finally, level 4 contains the so-called marginal analysis, i.e. everything that governs the formation of market outcomes. [...] [T]he first level of analysis, thus the one dedicated to informal institutions and social norms, is normally taken as a given in law and economics, whereas a deeper analysis of that level would enrich our understanding of the effectiveness and actual interpretation of legal rules in property and contracts, as well as the birth of formal institutions.”²⁰⁶ Though this last remark is valid, in relation to the law sensu stricto, it is important to focus on the levels 2 to 4, because a (R)IA can have an impact only on these three levels.

The main difference between the classic (R)IA and the nomocratic (R)IA is that the latter has no intention of knowing all the impacts of regulation on society (because they are anyhow not knowledgeable), but limits itself to discover some key facts:

- in the chapters ‘problem analysis en goal setting’: the nature of the proposed policy goal, i.e. whether it is nomocratic or telocratic; what is the policy aim: open-ended and focused on facilitate voluntary inter- and transaction, or focused on redistributive aims which will facilitate or favour certain groups within society;
- in the chapter ‘options’: analysis of the nature of the policy instrument: whether and to what extent the policy instrument in itself strengthens or mitigates the nomocratic or telocratic nature of the policy aim;
- in the chapter ‘impacts’: the impact of the particular policy instrument on the classic nomocratic basic individual rights and liberties (not only property rights and freedom of entrepreneurship or ‘free contracting’, but also freedom of speech, freedom of religion, etc.); to what extent are these rights and liberties eroded and undermined, in a direct or indirect way, in the short and in the long run.

The nomocratic (R)IA is essentially based on the judicial safeguarding of the classic individual rights and liberties, including property rights and freedom of entrepreneurship. It asks for a large part the same questions, like the analysis of the societal problems and its link with policy goals, the nature of the government intervention and the impact of regulation on the ‘nomocratic’ rights and legal order. But the main difference between the judicial safeguarding of individual rights against public policy, and the use of a nomocratic (R)IA in the judicial review of regulatory quality, is the attention in the nomocratic (R)IA for feasible alternative policy instruments in attaining the policy goals and the comparison between the impacts of all the options on the nomocratic rights when choosing the most optimal policy instrument. In this respects, the nomocratic (R)IA provides a guarantee for careful and reasonable policy making.

1. Problem analysis

As described above, the new institutional economics is partly a reaction against the welfare economics and its analyses of market failures. Therefore, the nomocratic (R)IA represents or displays this scepticism towards the existence of market failures, especially in the long run. But market failures may not be excluded in theory. That’s why the nomocratic (R)IA begins with its analysis whether there are market failures present and how damaging they are. Next, the nomocratic (R)IA also looks beyond the four well-known market failures of welfare economics by focusing on two ‘new’ market failures, or better ‘institutional’ failures: the

²⁰⁶ Renda A., o.c., p. 116-117

potential problems of transaction costs and exclusion costs. Both problems can disrupt the proper function of respectively free contracting and property rights.

So, the following questions concerning market failures may be asked:

- How disruptive and damaging are the market failures for the market functioning?
- If and to what extent can the identified market failures disappear in the long run?
- Is the market able to correct its own failures through voluntary actions and free exchanges (cfr. the Coase theorem)?
- Is there a problem within the society/economy of too high transaction costs that impede free market transactions and what is causing it?
- Is there a problem of too high exclusion costs in certain situations that render property rights difficult to value and uphold and what is causing it?

Next, due to the fact that society is full of existing regulations, leading to the reality that there exists no fully 'free market' (with full property rights and totally free contracting) anymore, the subsequent question is whether the identified societal problem is caused by regulation or by another form of compulsory government intervention (taxes, subsidies, etc.). This question is important because the zero-option in every present (R)IA must be the actual reality and not an idealistic or utopian situation where there is no regulation or other external 'institution'.

This may lead to the following questions on government failures:

- Is the problem due to a disruptive government intervention? What is the nature of this government measure, telocratic or nomocratic?
- What was the public justification for this government intervention? Is this given justification compatible with the facts (or reality)?
- How did this government intervention (regulation) come into existence? Which public choice forces were responsible for this government intervention?
- Did the government intervention stray from its original purpose? What (kind of) government failure caused this?

2. Goal setting

Neo-institutional economics claims that the safeguarding and even enhancement of the basic institutions of individual liberties are crucial for the proper functioning of a free society and economy. The basic goal of nomocratic policy is therefore to preserve as much as possible the nomocratic rights and legal order, including individual property rights and free contracting (free entrepreneurship).

The goal setting has to provide a specific policy solution for the societal problems which are analysed in the previous chapter. If there are indeed classical market failures involved, identify which goals need to be achieved, and their corresponding timeframes, in order to call the societal problem solved. Not an easy task to do because it is easier to do symptom-fighting than to find a solution for the real causes of market failures.

If transaction and exclusion costs are considered too high, define a level for these costs which is acceptable and does not distort market functioning too much. Also analyse the usefulness of policy goals which tackle the causes of these costs, for example the goals of improving the ways of knowledge gathering and property exchanges, in order to make free contracting and transactions of property rights more easily to perform.

These exclusion and transaction costs are far more pervasive than usually recognised. On a closer look, three of the four classical market failures can be defined in terms of transaction and exclusion costs (information asymmetries and public goods) or result from it

(externalities). Only monopolies are a problem apart, but most natural monopolies will disappear in time thanks to technological innovations and changing market circumstances.

When government failures are concerned, the (R)IA has to define whether and to what extent the government intervention needs to be abolished. Has the regulation to be removed completely or only mitigated or refocused? Specific goal setting may be required to define the necessary steps to achieve this abolishment.

In summary, the following reasoning needs to be undertaken:

- Is the aim or purpose of the policy intervention nomocratic or telocratic in nature?
- If the aim of the government intervention is to correct true market failures in a general manner or to remove distorting government failures, than the goal is nomocratic.
- If the purpose is to favour certain groups within society, and it is not open-ended but aimed at the realisation of a specific change within society, then it is telocratic.

With these analysis results, one is able to perform the judicial necessity test.

3. Options

The function of this analysis step is to evaluate which policy instruments are suitable to attain the policy goals, identified in the previous chapter. Again, a distinction has to be made here between market and government failures. The widest choice of options has to be considered when dealing with market failures. Especially non-coercive policy measures need to be taken into account.

If there are government failures (when the societal problem is solely caused by existing government intervention), the question becomes whether to abolish or only to mitigate the government intervention. One has to analyse in particular whether policy remedies for market failures are on closer look

- not necessary because of the self-healing nature of market transactions in the long run;
- may be impeded by government failures, due to public choice forces.

To conclude, the following questions need to be answered:

- How suitable is the policy instrument in achieving its goals? Whether and to what extent is it realising the policy aims?
- Are the market failures corrected, even in the long run? Did it create other (unexpected) market failures?
- How vulnerable is the policy instrument to be 'contaminated' by government failure? How pervasive are the 'public choice' forces in the adaptation and implementation of the policy instrument?

With these answers, it becomes possible to do the suitability test

4. Impacts

The importance of the chapter lays in the measurement and analysis of the impact of the policy instrument on the basic nomocratic individual rights and liberties in the short run, and on the grown nomocratic expectations, evolved from the nomocratic rights and liberties, in the long run. These impacts can be measured in the short run in terms of (growing) costs for free contracting and (increasing) value diminution of property. In the long run, one has to look at the willingness of market participants to do property transactions and other forms of free contracting. Is there a danger for trust within a society? But this is not the end of the analysis. Now, the jump has to be made from the particular or individual level to the general or more abstract level. What still needs to be analysed is the link between this impact on property rights and the potential degree or risk of 'undermining' the nomocratic legal order within a

society, leading to the conclusion that this regulation lacks quality, in the sense of legal uncertainty, opportunity costs and growing societal distrust.

The central question becomes then what the impact is of the ‘behavioural command’ of the regulation on the optimal use of knowledge within a society, i.e. what people like to do voluntarily. But how do we measure this? In theory, measuring the exact value loss of property and the lost value creation of the forbidden action, multiplied by the number of persons involved, would be more or less the same as calculating the efficiency losses or dead weight losses, based on the consumer and producer surpluses. But because these value losses differ from person to person, and measuring all this value losses one by one, is undoable, it is better to limit the analysis to:

- how big is the value loss for the average person,
- multiply this number with the amount of persons in order to have an understanding of the problem on macro-level.

Based on the nature of the policy instrument and the size of the impacts on the nomocratic individual rights, it is up to the courts to decide whether or not the policy instrument is proportional in its impact on the basic rights. The following guidelines may be followed in the proportionality test:

- If the policy goal and instrument are nomocratic in nature, than the policy instrument is proportionate;
- If the policy goals and instrument are telocratic in nature, than the proportionality of the policy instruments depends on the size its (negative) impact on the basic rights; the more substantial the impact (an important decrease on the value), to more likely it will become that policy instrument is disproportionate;
- In the case of a violation of the proportionality principle, the question arises for the courts whether to enforce the property rule or the liability rule. Again, a distinction has to be made:
 - If there is a total diminution of the value, then the policy instrument must be forbidden, restoring the full property and free exchange.
 - If there is (only) an substantial fall of the value, then the impact of the policy instrument must be compensated.

5. Implementation and enforcement

Because the nomocratic (R)IA is to be viewed in the light of judicial review of the proposed legislation, there is no need to evaluate its implementation requirements and steps. But, in order to be complete, the evaluation of the implementation actions is undertaken when we deal with government failures, f.ex. why the policy instrument has gone astray in its application or implementation, due to the major impact on nomocratic (property) rights.

Chapter II.D. A case-study: EU legislation on consumer protection in the financial sector

Let us now turn to a case-study to show what a nomocratic RIA would look like. But we start by illustrating what a classic (R)IA does and means in practice at the EU level. For that we take the striking example of the EU legislation on consumer protection in the financial sector. This case is also being analysed in the Ph.D. dissertation of dr. Renda.

II.D.1. What went wrong?

Renda sets the stage: “Achieving stringent consumer protection has been one of the most active policy commitments of EU institutions since the 1980s, which the debate on standard

form contracts that led to the enactment of Directive 93/13 on unfair clauses in consumer contracts. In light of the evolution of the law and economics literature, the attention of policymakers around the world has shifted gradually from a formalistic approach, focused on the moment in which unfair clauses are enshrined into final contractual document, to a more behavioural approach, aimed at capturing information manipulation by service providers to the detriment of less informed consumers.²⁰⁷ At the same time, “the new wave of consumer legislation tried to adopt a wiser approach to the protection of consumers: on the one hand, the ‘maximum harmonization’ clause aimed at the achievement of the internal market and, at the same time, the avoidance of unnecessarily strict rules in some countries; on the other hand, the behavioural approach marked a departure for previous legislative initiatives, which ended up imposing additional costs on the industry and, consequently, also on final consumer prices. This, in turn, tried to remedy the concerns of several academics, who during the 1990s often repeated ‘who protects consumers from consumer protection?’²⁰⁸

But the plot thickens as “[t]he more behavioural economics permeated the mainstream approach to consumer protection, the more retail financial services began to appear as a peculiar policy domain, warranting *ad hoc* treatment. This was partly due to the fact that nowhere as in this field, the informational asymmetry between the financial service provider and the individual customer can determine the latter’s unwanted exposure to financial risk. Given that in retail financial services, decisions under risk and ambiguity are the norm, the European Commission started to consider that a stricter approach could be warranted in this field, compared to all other fields of business-to-consumer contracts. Needless to say, the explosion of the subprime mortgage crisis confirmed the Commission’s view that the retail financial services were a unique one, to be kept under strict supervision.”²⁰⁹ This, of course, caused a further rise of the costs for the financial service providers.

The negative perception of financial service providers seem to be fully operational here: “As a matter of fact, this was a rather strange policy issue. [...] In [...] antitrust, tying was being increasingly considered as a lawful conduct, to be challenged by antitrust authorities only under specific circumstances. On the other hand, the European Commission was looking at the possibility of applying a *per se* rule on tying regardless of the market power held by the financial institution that engaged in this practice. The paradoxical result would have been that what was considered in principle lawful under Community competition law would have been subject to a *per se* rule under sectoral consumer protection legislation. As odd as it might seem, this is what happened. The study was delivered to the Commission by a group of external researchers at the end of 2009. Among the main findings of the study was that tying can increase switching costs and, consequently, reduce customer mobility. This effect depends also on what products or services are included in the bundle: for example, when products have different durations, the customer may be reluctant to switch to an alternative provider of a product with a shorter duration, even if this would be easy absent the tying or pure bundling practice. The lifespan of the contractual relationship thus tends to become equal to that of the product service with the longest duration. For this reason, products such as mortgage loans are often used as ‘gateway’ products by service providers wishing to retain their customers through cross-selling strategies.”²¹⁰ But this is not the end of the story.

Because the study also acknowledged that the situation is more complex than that: “In addition, the study highlighted that the impact of tying on switching costs depends on the ‘thickness’ of the contractual relationship: once the customer has invested in a relationship with a personal banker or financial advisor, he or she may find it beneficial to enter into

²⁰⁷ Renda A., o.c., p. 185

²⁰⁸ Renda A., o.c., p. 186

²⁰⁹ Renda A., o.c., p. 186

²¹⁰ Renda A., o.c., p. 188

multiple contracts and services with the same provider. At the same time, this also means that switching would be more complicated, as it would entail losing the investment associated with building a relationship with the service provider, and having to bear the additional cost of searching for an alternative one, and testing over time the quality of the new service provider. That is, in retail financial services customers normally ‘love’ tying. Even if it can reduce price transparency and price comparability, customers are reluctant to mix and match products by purchasing every financial service from a different provider. They hate mixing and matching. Accordingly, beyond offering better deals, competitors wishing to gain new customers would have to compensate them for the sunk, ‘transaction-specific’ investment they have faced to enter the current contractual relationship, as well as for the risk associated with entering a new contract or set of contracts. This can represent an important obstacle to customer mobility in the market, and is a structural friction that is very difficult to overcome in the retail financial services market.”²¹¹ So, so to speak, tying is not as much a policy of the suppliers, but is demanded by the consumers.

Renda adds: “The external study also revealed that price comparability is further jeopardized by practices such as ‘confusopoly’, i.e. situations where the competing offers on the marketplaces are structured so differently that it is impossible for an average consumer to compare them. But even in this case, reducing price transparency can help financial service providers in introducing cross-subsidies between different products, in particular in the case of add-on contracts: for example, sellers may entice customers to buy a particular product through a low ‘introductory’ price, knowing that they will be able to sell a number of additional products once the customer has entered the relationship. Sellers wishing to compete for only one of the bundled products may have to offer a product below their own cost in order to entice customers to switch. At the same time, however, the potential beneficial effects of tying practices include cost savings through economies of scope, more efficient pricing schemes, and ‘portfolio effects’ or ‘one-stop-shop’ effects for customers. In summary, the external study found very little grounds for banning tying, as this would have meant depriving consumers of beneficial effects on price and other contractual conditions. To the contrary the study found evidence that other widespread practices, such as ‘churning’ and ‘steering’ had to be banned as being stereotypical cases of aggressive and misleading practices, as such falling inevitably under the scope of the UCPD.”²¹²

Renda seems to be therefore quite negative about the blunt policy that the Commission adopted towards this issue: “Only partly conquered by behavioural economics, the European Commission missed the forest for the trees, and failed to see that, due to behavioural effects featured by relationship finance, banning tying would have meant nothing to customers, unless also other practices, such as mixed bundling and conditional rebates, were also prohibited. Unless what occurs from a legal, contractual perspective, from a behavioural economics perspective there is almost no difference between offering a bundle of products tout court and offering a discount for the purchase of two combined products. [...] Accordingly, banning tying was simply the wrong solution. Evidence from a survey of the EU member states confirmed that, in those countries that had decided to ban tying, mixed bundling had largely replaced it; and that even where tying was in principle feasible, banks resorted more often to mixed bundling: there’s no need to force customers into an unwanted tie-in, if you can nudge your customers into a more apparently spontaneous choice. In this respect, banks had invented libertarian paternalism long before Cass Sunstein.”²¹³

Renda concludes: “This tortuous story bears [...] important lessons. First, behavioural law and economics can teach policymakers how to avoid meaningless and ineffective rules.

²¹¹ Renda A., o.c., p. 188-189

²¹² Renda A., o.c., p. 190

²¹³ Renda A., o.c., p. 190

Second, banning contractual behaviour that can be mutually beneficial is unlikely to be an efficient solution, especially in consumer policy. Third, other remedies – coupled with rules aimed at contrasting churning, steering and similar practices – would prove way more effective, as testified by the analysis of national legislation in the EU27: for example, establishing switching facilities and web portals for customers wishing to switch to a new mortgage lender, as in the Netherlands, seems way more effective than prohibiting tying, as in France or Belgium. And more generally, increasing the ‘public and private’ production of third-party information is a better way to break the fiduciary tie established between consumers and their counterparts, rather than imposing 20-minute questionnaires as a proof that the service provider has checked the level of financial education and overall risk attitude of his client.”²¹⁴

II.D.2. Another possible analysis

Besides, behavioural (law and) economics, what may neo-institutional and Austrian economics teach us in this case? First, market processes are about solving the knowledge problem and coping with transaction costs. Therefore, the necessary learning process requires time to correct the initial mistakes (in for example in the price setting) that potentially have been made by one or more market participants. That means there is no such thing optimal static market setting or an objective optimal market result. Everything changes and changes other factors in the equation.

Next, consumer preferences are subjective, what may mean that lower prices could be a preference, but lower transaction costs at the expense of lower prices (the price of the convenience) could be a preference too. It is not a task of the government to determine that there have to be lower prices for a product at all cost (for example leading to higher transaction costs). This means that interference in the basic rules of market transactions can only be justified on grounds of severe market malfunctioning.

An example of this severe malfunction could be a situation where there no (more) market transactions at all as happened in the case of the ‘market of lemons’, described by Nobel Laureate G. Akerlof. Here, the problem is not the fact that there is asymmetric information as such, but the observation that this asymmetric information may lead to a fundamental distrust between market players, causing a dramatic fall in the selling of good cars, eventually ending up in a situation where only bad cars, the ‘lemons’, are (able to be) sold. So, as in particular monetary affairs, the “bad” drives out the “good”.

When applying the nomocratic (R)IA, the following questions and observations could be made when analyzing this specific legislation:

- Problem analysis: is there really a problem of market power abuse or information asymmetry, f.ex. keeping essential information secret, leading to fundamental distrust and a stop in market transactions? On closer look, the answer is that this is not the case and that therefore, there is no real market distortion.
- When defining the policy goal, it becomes clear that the policy aim is likely to be telocratic in nature, that is protecting the ‘poor consumers’ against the ‘evil banks’.
- When looking for options, the first rule should be to do no harm and choose the least intrusive instrument, also in order to avoid the (costly) evasive manoeuvres by market parties. As already mentioned, providing information through websites proved to be a much better solution for the (potential) societal problem, and improve competition.
- Finally, when looking at the impacts, it becomes clear that by limiting the free contracting of financial institutions, the regulation leads to a severe decline in, not

²¹⁴ Renda A., o.c., p. 190-191

only, producer surpluses, but also (and eventually) in consumer welfare in the broad sense. Moreover, if consumers feel themselves protected by government regulation, a moral hazard will evolve by being no more careful enough when dealing with financial institutions. Consumers may get ‘screwed’ in other financial transactions.

Chapter II.E. Conclusion – A new task for courts in the EU: dare to do your job!

To finalise this study, some personal remarks are in place in order to make the nomocratic (R)IA work. Basically, the courts in and of the EU have to dare to do their job by:

- upholding the rule of the nomocratic law as part of their constitutional duty;
- acknowledging the foundations of the capitalist economic order and the pressures that telocratic regulations put on our economic liberties.

Let us develop these two recommendations a bit further.

II.E.1. Upholding the rule of nomocratic law by courts

Our starting point is the legal theory of constitutionalism or the upholding of the constitution. But what does that mean exactly? “Embracing ideas of constitutionalism responds to the recognition of the dispersal of constitutionally relevant activities around the organs of the state and argues for the regulation of public power. A central aspect of the idea of limited power is that the three key state capacities – legislative, executive and judicial – should be exercised in institutionally distinct organs of the state, each of which has a counterbalancing effect on the powers held by the others. Constitutionalism, though not admitting of any agreed definition, extends beyond the idea that government should be subject to law (‘the rule of law doctrine’) to hold that the legislature itself should be constrained in what it may legislate for by higher constitutional norms. Amongst legal scholars the desiderata of constitutionalism extend to defining the limits on executive and legislative branches of government in terms that are ‘legally binding’.”²¹⁵ In other words, checks and balances.

Or as Hayek writes: “When Montesquieu and the framers of the American Constitutions articulated the conception of a limiting constitution that had grown up in England, they set a pattern which liberal constitutionalism has followed ever since. Their chief aim was to provide institutional safeguards of individual freedom: and the device in which they placed their faith was the separation of powers. In the form in which we know this division of power between the legislature, the judiciary, and the administration, it has not achieved what it was meant to achieve. Governments everywhere have obtained by constitutional means powers which those men had meant to deny them. The first attempt to secure individual liberty by constitutions has evidently failed. [...] Constitutionalism means limited government. But the interpretation given to the traditional formulae of constitutionalism has made it possible to reconcile these with a conception of democracy according to which this is a form of government where the will of the majority on any particular matter is unlimited. As a result it has already been seriously suggested that constitutions are an antiquated survival which have no place in the modern conception of government. And, indeed, what function is served by a constitution which makes omnipotent government possible? Is its function to be merely that governments work smoothly and efficiently, whatever their aims?”²¹⁶

The decline of constitutionalism is according to Hayek due to three causes: “It seems to me now that the reasons for this development were chiefly: the loss of the belief in a justice independent of personal interest; a consequent use of legislation to authorize coercion, not merely to prevent unjust action but to achieve particular ends for specific persons or groups;

²¹⁵ Scott C., “Regulatory Governance and the Challenge of Constitutionalism”, in EUI Working Paper RSCAS 2010/07, p. 2

²¹⁶ Hayek F., Rules and Order, o.c., p. 1

and the fusion in the same representative assemblies of the task of articulating the rules of just conduct with that of directing government.”²¹⁷ In brief, “constitutionalism is quite close to the aim of nomocratic policies to uphold the rule of law, because [t]he rule of law is a legal and constitutional concept to protect individual freedom and social peace which stipulates:

- that the people and government authorities should be ruled by the law and obey it;
- that the laws should be such that people are, on the whole, able and willing to be guided by them, more specifically, that protection from private license and anarchy is guaranteed;
- that government is placed under the law;
- that the laws are certain, general and non-discriminatory (universal);
- that the laws are generally in harmony with social values and internal institutions;
- that the law is enforced by impartial, rule-bound coercion, and adjudicated by an independent judiciary and impartial tribunals which follow due process; and
- that the law and its practice encourage an attitude of legality throughout the community.”²¹⁸

This means that “[t]he rule of law thus is a government-supported system of institutions intended to protect civil and economic liberties and to avoid conflicts:

- by protecting citizens from the arbitrary use of power by other citizens;
- by obliging agents with political power to find and enforce the law; and
- by binding agents with political power to the law in dealing with private citizens and acting within government.

These substantive elements, which have been developed in jurisprudence, relate directly to the fundamentals of institutional economics and are essential to the proper functioning of the capitalist system.”²¹⁹

But constitutionalism runs into trouble if the courts are not willing do uphold the constitution, more in particular the nomocratic laws. The apparent reluctance to enforce private property rights is voiced by Justice A. Scalia: “[W]e, the judiciary, do a lot of protecting of economic rights and liberties. The problem that some see, is that this protection in the federal courts runs only by and large against the executive branch and not against the Congress. We will ensure that the executive does not impose any constraints upon economic activity which Congress has not authorized, and that where constraints are authorized the executive follows statutorily prescribed procedures and that the executive (and, much more rarely, Congress in its prescriptions) follows constitutionally required procedures.”²²⁰ So, even Scalia seems to be in favour of the process-oriented review.

Scalia continues: “In this regard some conservatives seem to make the same mistake they so persuasively argue the society makes whenever it unthinkingly calls in government regulation to remedy a ‘market failure’. It is first necessary to make sure, they have persuaded us, that the cure is not worse than the disease – that the phenomenon of ‘government failures’, attributable to the fact that the government, like the market, happens to be composed of self-interested human beings, will not leave the last state of the problem worse than the first. It strikes me as peculiar that these same rational free-market proponents will unthinkingly call in the courts as a *deus ex machina* to solve what they perceive as the problems of democratic inadequacy in the field of economic rights.”²²¹

²¹⁷ Hayek F., Rules and Order, o.c., p. 1-2

²¹⁸ Kasper W. and Streit M., o.c., p. 168

²¹⁹ Kasper W. and Streit M., o.c., p. 167-168

²²⁰ ‘Scalia v. Epstein’, o.c., p. 3

²²¹ ‘Scalia v. Epstein’, o.c., p. 5

In theory, Scalia agrees with constitutionalism, but he sees practical problems: “But, the proponents of constitutionalized economic rights will object, we do not propose an open-ended, unlimited charter to the courts to create economic rights, but would tie the content of those rights to the text of the Constitution and, where the text is itself somewhat open-ended (the due process clause, for example), to established (if recently forgotten) constitutional traditions. As a theoretical matter, that could be done – though it is infinitely more difficult today than it was fifty years ago. Because of the courts’ long retirement from the field of constitutional economics, and because of judicial and legislative developments in other fields, the social consensus as to what are the limited, ‘core’ economic rights does not exist today as it perhaps once did. But even if it is theoretically possible for the courts to mark out limits to their intervention, it is hard to be confident that they would do so. We may find ourselves burdened with judicially prescribed economic liberties that are worse than the pre-existing economic bondage.”²²²

Epstein opposes Scalia’s reasoning, but he begins by admitting that “[t]here are powerful reasons why judges may do badly in this endeavour [to vindicate these basic economic rights by constitutional means]. They are isolated, and they tend to be drawn from political or social elites. Their competence on economic matters is often limited. When they pass on complex legislation, they often misunderstand its purpose and effect. By any standard, the error rate or their decisions has been high.”²²³ But subsequently, Epstein starts his counter-argument: “In my view, Scalia has addressed only one side of a two-sided problem. He has pointed out the weaknesses of judicial action. But he has not paid sufficient attention to the errors and dangers in un-channelled legislative behaviour. The only way to reach a balanced, informed judgment on the intrinsic desirability of judicial control of economic liberties is to consider the relative shortcomings of the two institutions – judicial and legislative – that compete for the crown of final authority. The constitutionality of legislation restricting economic liberties cannot be decided solely by appealing to an initial presumption in favour of judicial restraint. Instead, the imperfections of the judicial system must be matched with the imperfections of the political branches of government.”²²⁴

Epstein takes the following steps in his reasoning:

- “Intellectually, we must conclude that much of the impetus behind legislative behaviour is to induce forced exchanges – to take from some people more than they get in exchange, in order to provide some benefits to those who happen to control the political levers. To some extent, this is unavoidable, since we need a system of collective controls in order to operate the police, the courts, the national defence, and so on. And opportunities for abuse in government operations are inseparable from that collective need. The theory of constitutionalism [...] tries to find a way to minimize the sum of the abuses that stem from legislative greed on the one hand, and judicial incompetence on the other.”²²⁵
- “[The U.S.] Constitution reflects a general distrust toward the political process of government – a high degree of risk aversion. That is why it wisely spreads the powers of government among different institutions through a system of checks and balances. To provide no (or at least no effective) check on the legislature’s power to regulate economic liberties is to concentrate power in ways that are inconsistent with the need to diversify risk. To allow courts to strike down legislation, but never to pass it, helps to control political abuse without undermining the distinctive features of the separate branches of government. Once we realize that all human institutions (being peopled by people) are prey to error, the only thing we can hope to do is to minimize those errors

²²² ‘Scalia v. Epstein’, o.c., p. 6

²²³ ‘Scalia v. Epstein’, o.c.,p. 9

²²⁴ ‘Scalia v. Epstein’, o.c.,p. 10

²²⁵ ‘Scalia v. Epstein’, o.c., p. 11

so that the productive activities of society can go forward as little hampered as possible.”²²⁶

- “This judicial deference in the protection of economic rights has enormous costs. The moment courts allow all private rights to become unstable and subject to collective (legislative) determination, all of the general productive activities of society will have to take on a new form. People will no longer be able to plan private arrangements secure in the knowledge of their social protection. Instead, they will take the same attitude toward domestic investment that they take toward foreign investment. Assuming that their enterprise will be confiscated within a certain number of years, domestic investors will make only those investments with a high rate of return and short payout period, so that when they see confiscation coming, they will be bale to run.”²²⁷
- “When one compares the original Constitution with the present state of judicial interpretation, the real issue becomes not how to protect the status quo, but what kinds of incremental adjustments should be made in order to shift the balance back toward the original design. On this question, we can say two things. First, at the very least, we do not want to remove what feeble protection still remains for economic liberties. Any further judicial abdication in this area will only invite further legislative intrigue and more irresponsible legislation. [...] Second, since courts are bound to some extent by a larger social reality, we cannot pretend that the New Deal never happened. Rather, we must strive to regain sight of the proper objectives of constitutional government and the proper distribution of powers between the legislatures and the courts, so as to come up with the kinds of incremental adjustments that might help us to restore the proper constitutional balance.”²²⁸
- “Judicial restraint is fine when it keeps courts from intervening in areas where they have no business intervening. But the world always has two kinds of errors: the error of commission (type I) and the error of omission (type II). In the context of our discussion, type I error refers to the probability of judicial intervention to protect economic rights when such intervention is not justified by constitutional provisions. And type II error refers to the probability of forgoing judicial intervention to protect economic liberties when such intervention is justified. This second type of error – the failure to intervene when there is a strong textual authority and constitutional theory – cannot be ignored.”²²⁹
- “What Scalia has, in effect, argued for is to minimize type I error. We run our system by being most afraid of intervention where there it is not appropriate. My view is that we should minimize both types of error. One only has to read the opinions of the Supreme Court on economic liberties and property rights to realize that these opinions are intellectually incoherent and that some movement in the direction of judicial activism is clearly indicated. The only sensible disagreement is over the nature, the intensity, and the duration of the shift.”²³⁰

Epstein ends with a grim view on the future: “At this point, the division of power within the legal system is not in an advantageous equilibrium. If the judiciary continues on the path of self-restraint with respect to economic liberties, we will continue to suffer social and institutional losses that could have been reduced by the prudent judicial control that would result from taking the constitutional protections of economic liberties at their face value.”²³¹

²²⁶ ‘Scalia v. Epstein’, o.c., p. 11

²²⁷ ‘Scalia v. Epstein’, o.c., p. 14

²²⁸ ‘Scalia v. Epstein’, o.c., p. 15

²²⁹ ‘Scalia v. Epstein’, o.c., p. 15

²³⁰ ‘Scalia v. Epstein’, o.c., p. 15-16

²³¹ ‘Scalia v. Epstein’, o.c., p. 16

Hayek also had a view on this topic, though somewhat from a different perspective: “The effective limitation of the powers of a legislature does therefore not require another organized authority capable of concerted action above it; it may be produced by a state of opinion which brings it about that only certain kinds of commands which the legislature issues are accepted as laws. Such opinion will be concerned not with the particular content of the decisions of the legislature but only with the general attributes of the kind of rules which the legislator is meant to proclaim and to which alone the people are willing to give support. This power of opinion does not rest on the capacity of the holders to take any course of concerted action, but it is merely a negative power of withholding that support on which the power of the legislator ultimately rests. [...] These restraints on all organized power and particularly the power of the legislator could, of course, be made more effective and more promptly operative if the criteria were explicitly stated by which it can be determined whether or not a particular decision can be a law. But the restraints which in fact have long operated on the legislatures have hardly ever been adequately expressed in words. To attempt to do so will be one of our tasks.”²³²

II.E.1. Acknowledging the concept of regulatory pressures on economic liberties

Whether we like it or not, our political and legal system is based on the capitalist structures of our economy. At the same time, as we saw earlier, our political and legal system as developed since the Enlightenment, provided the foundations for the development of capitalism. So, there is a mutual causal link between capitalism and the democratic rule of law: “[C]apitalism [...] is the economic system that is based predominantly on private, autonomous property ownership and the spontaneous coordination of property owners by competition. The capitalist system is based on institutions that ensure respected and secure property rights and liberties of autonomous property use.”²³³ But at the same time, economic transactions shaped the legal system: “Many institutions have developed spontaneously to order and facilitate exchange relationships and to give business partners more confidence in what to expect. Institutions make the exchange possible and develop to make exchange transactions less costly and risky, allowing markets to become more effective.”²³⁴

But, as we have seen, there exist a major risk for property rights: “These advantages of the competitive use of property rights – of what might be called the ‘constitution of capitalism’ – are easily undermined by political action that is driven by political rivalry. It is therefore desirable to attach a high moral value to protecting the free use of private property in competition. Property rights protection and free contracting should be elevated to principles with a high constitutional status, into overriding, universal institutions which govern the making and implementation of lower-level rules and which cannot be overturned by simple court judgements, simple parliamentary majorities or mere administrative action to suit specific cases. If the basic institutions of a competitive economy enjoy legal protection, this establishes trust in self-controlling; self-organising economic system in which policy interventions are used sparingly and in which ordinary citizens can thrive.”²³⁵ We may call this impact of regulation in property rights as the ‘regulatory burden’ or ‘regulatory pressure’ on individuals and on society (economy) as a whole. Though some legal theorists struggle with this concept of regulatory burden or pressure and prefer more the much more vague concept of regulatory quality, it is clear that there can be no regulatory quality in a society, when the regulatory burden has become too high. Courts have to accept this general principle.

As we have explained earlier, public choice drivers raise this regulatory burden. Or as Renda words it: “It has, however, also been shown that there are good theoretical reasons for

²³² Hayek F. , Rules and Order, o.c., p. 93

²³³ Kasper W. and Streit M., o.c., p. 175

²³⁴ Kasper W. and Streit M., o.c., p. 177

²³⁵ Kasper W. and Streit M., o.c., p. 253-254

expecting the regulatory burden to be excessive, and hence a critical approach policy stance. Though there is no a priori anti-regulation case in aggregate, there are reasons for a sceptical approach on a case-by-case basis.²³⁶ It must also be clear that “the choice of instrument affects the scope for capture. Capture is easier when command-and-control is used. [...] Limiting the scope for capture can be furthered not only by moving towards more market-based instruments, but also by designing institutions specifically to counteract capture. Instrument choice focuses on the informational asymmetry, whereas institutional design focuses on the differing incentives in the principal-agent network. Companies try not only to exploit their informational advantages, but also to bias the incentives of regulators to their own objectives. There are several elements to the design of institutions to limit capture: establishing an independent remit with defined objectives; setting the informal duties of regulatory bodies; limiting personalization of regulation through the corporate structure of regulatory bodies; and setting the rules for employees of regulatory bodies.²³⁷ This design only applies in the field of governance.

Courts too have to perform a proportionality test on a case-by-case approach, and starting from the concept or regulatory pressure because we have to acknowledge that: “Crude regulatory-reform initiatives are almost certain to fail. The much harder task of designing appropriate regulation on a disaggregated basis is likely to be more rewarding in increasing economic efficiency – although it should be conducted with the tendency to oversupply regulation in mind. Leaning into the wind of regulation requires more robust analysis of each regulatory instrument, but this is not well achieved through rough-and-ready RIAs, the BRTF’s five general principles, or, worse, [...] ‘one in, one out’ rules. Such policies will not only fail to be delivered, but delivering them may, in any event, be economically detrimental.”²³⁸ To this end, RIAs have to be written from the viewpoint of regulatory pressures on individual property rights, and therefore on the economy as a whole.

So, courts play an essential role in trying to lower the regulatory burden, or at least, to stop the further increase of it, by performing the balance test between the basic nomocratic (property) law the political attractive but potentially dangerous telocratic regulation quite thoroughly. Let us hope they have the stomach to do that because the tools are at their disposal. With this judicial stick behind the door, we also hope that governments and legislatures too will do their homework when designing and implementing regulating in a better way...

²³⁶ Renda A., o.c., p. 177

²³⁷ Renda A., o.c., p. 180

²³⁸ Renda A., o.c., p. 184