Toward an Economic Theory of Federal Jurisdiction

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You cannot be a federal court of appeals judge for five months—you cannot be one for two weeks—without realizing that a big part of your job is policing the allocation of responsibilities between the state courts and the federal courts. But adjudication is like needlework: you spend much more time thinking about getting the thread in the right place than about the overall pattern—which, to complete the analogy, probably was supplied to you by someone else. So I am pleased to have this opportunity to step back and think about the allocation of responsibilities between state and federal courts more systematically than I am able to do in my day-to-day work as a judge.

The specific question I want to address today is how economics, and specifically the economic theory of federalism, can aid decisions with respect to that allocation. I put it as a question not only because my thoughts are as yet very tentative, and not only because any thoughts I express outside of the pages of the Federal Reporter on matters within the purview of the federal courts have to be tentative, but also because the relationship between the states and the federal government cannot be regarded solely as an expedient one, designed to promote efficiency and hence alterable from time to time as the needs of efficiency change or are perceived differently. We sometimes forget that the original thirteen states were in existence before the Constitution was enacted, that the subsequent states were admitted to the union on the same terms as the original thirteen, that the Constitution is at least in a limited sense a compact among the states, and that the states retain to this day whatever sovereignty they have not delegated to the federal government. The issue is not for us, as it is, for example, for the French, simply whether it would be better to have

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more or to have less centralization of government, unless we are prepared to alter the Constitution in the most fundamental way imaginable.

But having entered this caveat to treating the allocation of responsibilities between the state courts and the federal courts as purely a question of maximizing efficiency, I shall in the remainder of this talk—in the spirit of academic speculation—do just that. I shall even venture, without attempting to develop or justify, the suggestion that the economic theory of federal jurisdiction to be sketched here is derivable from that neglected document of eighteenth-century economics, *The Federalist*. Moreover, Article III of the Constitution creates a very large discretionary zone so far as the creation and responsibilities of the lower federal courts are concerned; it may be entirely appropriate to use economics to guide the exercise of that discretion.

In discussing the optimal—that is to say the efficient—allocation of responsibilities between the state courts and the federal courts, it can make a big difference whether you look upon the two court systems as they are in fact, with systematically different conditions of employment, or, as they might be abstractly conceived, as identical in every respect except their jurisdiction. It is a fact that the conditions of employment are on average superior for federal as opposed to state judges.\(^2\) All federal judges have lifetime tenure in a most literal sense which excludes forced retirement at any age, and they are paid higher salaries than most of their state counterparts. The difference in tenure, it should be noted, increases the relative independence of the federal judge in two ways: directly, by protecting him from retribution for unpopular decisions; but also indirectly, because by allowing him to remain fully employed until death it makes alternative employment less attractive. Judicial independence is threatened by the carrot as well as by the stick.

Should we regard these differences in the conditions of employment between state and federal judges as accidents that should not influence the ideal allocation of responsibilities between them? I think not, not only because they have been so persistent, but also because they are themselves implied by the economic theory of federalism that I am about to expound. They therefore belong in

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an analysis of optimal allocation. The big economic difference between state governments and the federal government is that the latter has more monopoly power than the former do. If you don't like Huey Long's Louisiana, then you can move to Alabama or Texas or any of the other (then) 47 states; but it is much harder to emigrate. The fact that the ability to vote with one's feet is much greater at the state than at the federal (and at the local than at the state) level makes for a greater competitive check on the abuses of governmental power at the state level.

The potential monopoly power of the federal government was much in the thinking of the framers of the Constitution, and one of the checks they set up against it was the independent judiciary with its lifetime tenure and secure (inflation aside) compensation. This costly check—for it is very inefficient to have a body of officials immunized from the usual incentives to efficient performance—is less necessary, perhaps unnecessary, at the state level, where the power to be checked is not nearly so great. This incidentally implies—whether correctly or not is a question for future research—that the employment conditions of state judges should have deteriorated over time relative to those of federal judges as interstate mobility has grown, federal control of state government has grown, and therefore the power of states has declined and with it the social benefits of having independent state judges. This might, if true, also explain the concomitant growth in the jurisdiction of lower federal courts—that is, the substitution of federal for state judges.

Now if we have a body of judges, the federal judges, who, for reasons derivable from the economic theory of federalism, have more secure and attractive employment conditions than do the state judges, and as a result greater independence from political influences and constraints, then in deciding how responsibilities should be allocated between state and federal judges we should take into account this greater independence of the federal judges; it is a factor intrinsic to the economic theory. So, although for some purposes the relevant independence of the federal judges is their independence from control by state governments, and would exist even if federal judges did not have better tenure conditions than state judges, the independence of the federal judges from federal political control should also be considered in determining

3 See The Federalist No. 78 (A. Hamilton).
the optimal allocation of responsibilities between the state and the federal courts.

I have already remarked that one important facet of the economic theory of federalism is the competitive benefits of state as opposed to federal provision of public services. This is an obvious point but also one that is easy to overstate. It is true that if a faction or, as it is nowadays called, an interest group, takes control of a state government and uses its control to try to redistribute wealth to itself, at some cost in efficiency analogous to the efficiency loss from monopoly in the economic marketplace, its power to exploit will be limited by the threat that those whom it is trying to exploit will move to another state; the corresponding threat in the case of the federal government's being taken over by a faction would be much less significant. But we also have to ask which government—state or federal—is more likely to be taken over by a faction, and here the answer that The Federalist gave—and that retains at least some force today—is state government. The larger the polity, the higher are the transaction costs of putting together a coalition that will dominate the polity. So monopoly achieved is a more serious problem at the federal than at the state level, but the probability that it will be achieved is lower. It is therefore unclear at what level the expected cost of monopoly is higher. Risk aversion may break any tie in expected cost. Even if the expected cost of monopoly is the same at both the state and the federal levels—and presumably it is not higher at the state level—the consequences of monopoly are potentially much greater at the federal level in the (less likely) event that it occurs there. The risk averse will therefore rate the expected disutility of the monopoly threat as greater at the federal than at the state level. Since most people are risk averse with regard to large stakes, and since this particular risk is not easy to insure against, the monopoly danger may well be greater in an expected-utility, even if not expected-cost, sense at the federal than at the state level. I conclude, by this rather tortuous route, that the competitive argument for preferring (other things being equal—an important qualification elaborated below) state to federal government is valid.

There is another valid, and even more familiar, argument for preferring state government—the “experiments in separate laboratories” argument—which can also be given an economic inter-

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4 See The Federalist No. 10 (J. Madison).
Economic Theory of Federal Jurisdiction

Decentralization provides valuable information about the provision of public services because diverse polities naturally hit on different solutions to common problems and the results of these different solutions can be compared. In other contexts this is called "yardstick competition." One might prefer to have a number of separate electrical utilities in the U.S. even if each had an exclusive sales area such that there was no competition among them in the usual sense, that is, for customers.

Decentralization has another important dimension, this one related to costs of production. Beyond a certain point, which probably was reached long ago in American government, further centralization in the provision of goods or services encounters diseconomies of scale which reduce efficiency. The parceling out of governmental responsibilities among the fifty states and the federal government allows us to avoid a single, monstrous bureaucracy which, even if not tyrannical, would probably be highly inefficient.

The factors I have discussed create a presumption in favor of shifting governmental power from higher to lower levels, from broader to narrower jurisdictions—for present purposes, from the federal to the state level. But another factor limits the movement in this direction, and that is the familiar problem of externalities. If either the benefits or the costs of a governmental action are felt outside the jurisdiction where the action is taken, and the costs of negotiations between governments are assumed, for reasons I cannot begin to go into here, to be very high, then there is a strong argument that the responsibility for the action should be assigned to a higher level of government with a broader jurisdiction. On the benefits side national defense is the classic illustration, but a more pertinent one is the setting by one state of generous welfare benefits which attract people from other states so that a benefit is conferred on persons outside the jurisdiction. On the costs side one can think of several good examples: the state that pollutes the headwaters of a river that runs through another state; the state that imposes a tax on a good which is sold mainly out of state and for which demand is inelastic, so that the incidence of the tax is borne largely out of state; and the automobile accident in which a state resident injures an out-of-stater—though we shall see shortly that it makes a difference whether the accident occurs in or out of the state.
The foregoing analysis can be used to derive an optimal allocation of lawmaking responsibilities between the states and the federal government, an allocation that would resemble, but would of course not be identical to, the allocation we actually observe in the U.S. today. And though I have been speaking thus far of allocation of substantive areas of law rather than of jurisdiction, there is a close relationship between these two allocations. I suggest that whenever the economic theory of federalism assigns substantive lawmaking responsibility to the federal government, the economic theory of federal jurisdiction would assign jurisdiction (whether exclusive or concurrent is an issue that I will not try to resolve in this talk) to the federal courts. Since state judges are assumed in my analysis to be less independent of state political forces and pressures than are federal judges, there is a legitimate basis for concern that a state court will be an unsympathetic tribunal in a case where a federal right has been created in order to correct an interstate externality. Thus, if the federal government has decided to regulate water pollution because interstate externalities deprive states of enthusiasm for this task, it is logical to assume that state judges, identifying much more than do federal judges with the dominant political interests in the state, would lack enthusiasm in enforcing the federal statute.

Even where substantive lawmaking power remains with the states under the optimal division of lawmaking responsibilities, there is a role for the federal courts. Let me give an example. Because the costs and benefits of the automobile (and other) accidents that occur in a state are felt largely within that state, the optimal, and of course the actual, responsibility for tort law is mainly the state's rather than the federal government's. But sometimes a state resident's tort victim is an out-of-stater, and then there is a possible cost externalization. I say "possible" rather than "actual" because if the accident occurs inside the state, then the cost of the accident may be internalized, at least in part; the state is the loser if people are deterred from traveling in it because its tort rules as applied are stacked against nonresidents. And in the case of disputes over contracts between residents and nonresidents there should be no cost externalization at all. The Coase theorem implies that any unequal application of state laws to bargains with out-of-staters will be nullified by adjustments in the

terms of the bargains to reflect the probability of such an application.

This analysis suggests an economic rationale for some part of the diversity jurisdiction of the federal courts, but for much less than we now have or would have even if the jurisdiction were confined, as almost everyone who thinks about the question recommends that it be confined, to cases where a nonresident who is suing (or being sued) by a resident seeks to bring the case in (or if he is the defendant remove it to) a federal court. In all contract and most tort cases the economic theory of federalism implies that local rules will not be applied unequally to nonresidents, because those nonresidents are linked economically with residents.

Notice that the economic theory of diversity jurisdiction that I have just sketched is wholly independent of the degree to which a state's residents are xenophobic. Even if they have no particular hostility to out-of-staters, their economic self-interest will give them and their agents, including their judges, an incentive to apply the laws unequally to nonresidents in the limited class of tort cases indicated above. Perhaps surprisingly, to the extent that diversity jurisdiction is based purely on a concern with localism or xenophobia, rather than on a concern with externalities, it lacks a clear economic rationale. To discriminate against people whom you don't happen to like is to indulge a taste, and preventing people from indulging their tastes is, at least prima facie, inefficient.

I don't wish to deny that the framers of Article III may have been concerned with lessening interstate hostility, and not just with overcoming externalities. They wanted to create a nation, and not just a common market. But today, when the growth of education, communications, and interstate mobility has greatly lessened the parochialism with which the framers may have been primarily concerned, it is useful to note that there is an economic rationale, untouched by considerations of parochialism, for retention of at least a part of the current diversity jurisdiction authorized by Article III.

The economic rationale for the insistence of the federal government, as in the Federal Tort Claims Act, to confine suits against it to federal courts is the same. If a postal van runs down a state resident, and the resident sues the Postal Service in state court, then the judge, to the extent he considers himself an agent of the state rather than of the impersonal "law," has an incentive to resolve any doubts against the Postal Service, since the costs of a
judgment against the Service would be borne by the federal taxpayer and thereby diffused throughout the nation, whereas the benefits would be concentrated in the state.

I want also to suggest a limited economic justification for the existence of federal criminal laws and their enforcement in federal courts. I am not interested in federal regulatory laws that happen to carry criminal sanctions, but rather in the common type of federal criminal statute that punishes a local crime such as extortion, kidnapping, or trafficking in narcotics or pornography because of a supposed and usually minor impact on trade among the states. In a few of these cases there is a genuine externality justifying federal regulation—I have in mind particularly the production of pornography in one state for sale in another. And in a few the criminal activity takes place in so many states that coordination of different state law enforcement authorities would be difficult. But the main justification for these criminal statutes is, I think, different and, incidentally, unrelated to interstate commerce or multi-state incidence. It has to do with what I earlier suggested was the greater vulnerability of states to control by factions. One aspect of this is the greater vulnerability of state law-enforcement agencies, including courts, to domination by corrupt elements. The economic theory of federalism predicts that federal authorities will be less vulnerable to corruption, and this becomes an argument for using them to police, with the aid of their own courts, certain basically local problems. I am thus suggesting an analogy between federal criminal jurisdiction, or at least a part of it, and the Constitution's guarantee to the states of a republican form of government.6

The most interesting and controversial issue in the area of federal jurisdiction, and not only from the perspective of this talk, is the role of the federal courts in enforcing rights that do not derive from the economic theory of federalism. I have in mind particularly the rights conferred by the Bill of Rights and made applicable to the states by the Supreme Court's very liberal interpretation of the due process clause of the Fourteenth Amendment, and the rights independently conferred against state action by the equal protection clause of the Fourteenth Amendment. Few if any of these rights can be derived from a concern with externalities.

6 U.S. CONST. art. IV, § 4.
Some, such as the right created in *Shapiro v. Thompson*\(^7\) to collect state welfare benefits no matter how recent one's arrival in the state, flout the economic analysis in a rather blatant fashion. Most are simply unrelated to it. The oppression of blacks by the southern states was a terrible thing, but unless one treats moral outrage as a cost—which robs the concept of externality of most of its utility—the costs of that oppression were borne mainly by the southern rather than the northern states. And so with rights against age discrimination, sex discrimination, cruel and unusual punishments, double jeopardy, denial of counsel to indigent criminal accused, and the other similar rights that give rise to a large part of the jurisdiction of the federal courts today.

If I am correct that there is little interstate spillover effect from violations of such rights, then the question arises what, if any, economic justification there is for having them litigated in federal rather than state courts. It seems odd to say that state judges will be less sympathetic on average than federal judges to claims of, for example, denial of counsel, since whatever unfairness or error is caused by such denial will be felt by residents of the state and not by people outside the state. But now recurs the point that federal judges are likely to be more independent than state judges. While the federal judges' independence stems, as I said earlier, from considerations almost entirely unrelated to the enforcement of any rights against state governments, given that we have this corps of more independent judges there is an argument for giving them responsibility for enforcing such federal rights as are likely to be asserted by people who are politically disfavored at the state level.

We must distinguish carefully, however, between rights that are unpopular because they are thought to be foolish or have no real basis in the Constitution and rights characteristically asserted by politically vulnerable groups; it is only the latter for which a case for federal enforcement can be made on economic grounds. Moreover, this is not an exhaustive classification. In particular it leaves out federal rights that are popular, or at least that are not asserted by politically vulnerable groups. An example is the right against age discrimination. The aged in our society are a potent political interest group at the state as well as the federal level. The fact that they have been able to obtain federal legislation in

\(^7\) 394 U.S. 618 (1969).
their favor does not imply that state judges, if given the responsibility for enforcing that legislation, would not do so sympathetically. The case for federal court jurisdiction over cases arising under such legislation is not clear to me.

I have suggested in this talk that the economic rationale of federal jurisdiction is more limited than the actual extent of that jurisdiction today. But it does not follow that the jurisdiction should be cut down. I have not considered the benefits of shifting judicial responsibility from the federal to the state level in cases where the factors discussed in this talk do not argue for federal jurisdiction. The main benefit is, of course, to reduce the danger of a federal monopoly of political power by shifting governmental power, here exercised by judges, to the lowest possible level consistent with efficiency. A subsidiary benefit is to reduce the diseconomies of scale that have begun to impair the effective operation of the federal court system. Shifting more judicial responsibilities from the federal to the state courts provides a means of decentralizing the American judiciary. But I do not wish to press this point too hard. Reducing your workload by increasing someone else's is not a dependable formula for increasing efficiency. To analyze this issue, however, would carry me far beyond the intended scope of this talk, which has had the modest objective of proposing a new approach to thinking about the allocation of responsibilities between the state and the federal courts—an economic approach.