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# **Method and Morals in Constitutional Economics**

Essays in Honor of James M. Buchanan



Springer

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With 17 Figures and 11 Tables

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## Preface

This *Festschrift* was "presented" in electronic form to Buchanan on the occasion of his eightieth birthday on October 3, 1999, after dinner in Fairfax, Virginia.

As one might have expected, the response to our call for papers was voluminous. In looking over the many contributions, we felt that a "published" *Festschrift* was also possible and fitting for the eightieth birthday of so prodigious and influential a scholar as Professor Buchanan. To that end we have assembled the following volume. In selecting the papers to be included here we have basically tried to choose those papers which in some way bear on Buchanan's contributions. Perfectly good papers about issues not related to Buchanan's research agenda or not referring directly to Buchanan's work were not included. Space constraints did not allow universal coverage, so choices had to be made. It should be stated clearly that these were *our* choices based on the criterion that the contribution be relevant to Buchanan's work. Buchanan had nothing whatsoever to do with the selection of papers for this volume.

Once choices had been made, we arranged the papers by subject matter ranging from various aspects of Buchanan's work in economics, political science, philosophy, and related areas, to some more personal recollections of Jim as a professor, friend, and colleague. Including the latter material was also *our* decision, and this probably represents a choice with which Jim would not have agreed. We think, however, that the reader will find these pieces interesting and informative.

In transcribing papers from the electronic to the written form, some editing has been necessary. We have, however, exercised our editorial responsibilities lightly – in what one might call a "Kantian" spirit, respecting the distinctive "voices" of the various contributors. Small changes have been made here and there, where such changes seemed necessary to clarify meaning, but otherwise "stylistic accents" have been left in place. It has seemed to us that the international community represented in this volume ought to be allowed to speak as an international community, without the heavy-handed imposition of any one "approved" style.

Surely, Buchanan and his work need no elaborate introduction here. He is one of the preeminent economists and scholars of this or any other genera-

## PREFACE

tion. For those interested in reading or rereading Buchanan directly, we note that Liberty Fund is in the process of publishing *The Collected Works of James M. Buchanan*, forecast to include 20 volumes of which 17 have already been published.<sup>1</sup>

This volume is simply testimony to the fecundity of Buchanan's work. These papers are by friends and colleagues of Buchanan, and in them one can easily see how their work and the ongoing research agenda of modern social science have been significantly impacted by the creativity and contributions of James M. Buchanan. Indeed, the quality and quantity of Jim's colleagues and friends, in this volume are apparent, and represent yet another aspect of a scholarly life well lived and activity in progress as we speak. As we have said elsewhere, there are many gifts under Jim's tree, not the least of which is a devoted network of former students, colleagues, and friends, whose tribute to Jim in this volume is the highest that they could possibly pay him – they have taken his ideas seriously.

**Geoffrey Brennan** (Australian National University), **Hartmut Kliemt** (University of Duisburg) and **Robert D. Tollison** (University of Mississippi)

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<sup>1</sup> G. BRENNAN, H. KLIEMT AND R. TOLLISON (Eds.): *The Collected Works of James M. Buchanan*, Indianapolis (Liberty Fund), forthcoming.

## A Poem

PETER BERNHOLZ

To My Friend James M. Buchanan  
At the Occasion of His 80th Birthday

Eighty years and still creative,  
Gentleman from Tennessee,  
From a modest farm a native,  
Nobled by a King's decree.

Long ago he once decided  
Ploughing should not be his lot;  
In the war he joined the navy  
Without firing any shot.

Went along then to Chicago,  
Found as mentor there Frank Knight,  
And from Wicksell's German writings  
Got ideas fresh and bright.

In the blue hills of Virginia  
Soon was heard his steady voice,  
Where he stubbornly presented  
What was named then Public Choice.

Well-known everywhere at home  
And renowned soon far abroad,  
Visitors flocked to his office,  
And he travelled all the globe.

Liberty, he spread the message,  
Can be even saved today,  
If created constitutions  
Keep the government at bay.

His collected works are now presented,

## A POEM

Twenty volumes as we hear,  
But the editors will be requested  
To extend them year by year.

Offering congratulations,  
Impressed by such fertility,  
They are joined by expectations  
Of future creativity.

## To Jim at Eighty

ALLAN H. MELTZER

Jim Buchanan challenged welfare analysis  
At the time in a state of paralysis.  
His work had tremendous impact,  
It showed how governments react,  
That officials, bureaucrats, and others  
Do not treat all men as brothers.

It was not as Samuelson presumed.  
And most of us assumed,  
That governments sought to achieve –  
This is really hard to believe –  
Only those outcomes that are best,  
For each one of us and all the rest.

Political economy has thrived,  
As a sub-discipline, it has now arrived.  
On his eightieth birthday, we salute  
And gladly offer this tribute.  
To Jim who took the lead  
In making Public Choice succeed.

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**Part I**

**Buchanan and Public Choice  
in Historical Perspective**

# 1 Onwards and Upwards – James Buchanan at 80<sup>1</sup>

GEOFFREY BRENNAN

- I. Titles
- II. But Is It Descriptive?
- III. But what of "Upwards"?
- IV. Implications of "Upwards"
  1. The Nature of Economic Enquiry
  2. Behavioural Implications
  3. But what of Buchanan's Work Will Survive this Test?
- V. The Personal Legacy
- VI. Conclusion

## I. Titles

Anyone who has ever collaborated with Jim Buchanan will have learned that titles are important. One can spend several hours with Jim brainstorming to get something that is both descriptive and appropriately euphonious – and if nothing suitable emerges, you can be prepared to revisit the whole issue for days, even weeks sometimes, until the right note is struck. The results of this kind of effort can be seen in such nicely judged constructions as "The Calculus of Consent", or "The Limits of Liberty", or "Democracy in Deficit", or "Politics without Romance". I remember as an undergraduate student in far-off Australia finding on my reading list a piece entitled "Politics, Policy and

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1 This paper is an edited version of an address delivered on the occasion of James Buchanan's eightieth birthday celebrations, held on October third, 1999 in Falls Church, Virginia. It very much bears the marks of its status as an "occasional" piece. It is reproduced here because the editors felt that it would be of interest to a wider audience than the two hundred or so attendees at the celebratory dinner, and not least to the readership of *Public Choice*. From *Public Choice*, July 2000. [I am grateful to Jonathan Pincus for comments on an earlier version]

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the Pigovian Margins" and wondering long and hard at that title. What strange and wonderful imaginings those 'Pigovian margins' conjured in the young Geoffrey's uninitiated mind. Not everyone, I guess, could strike poetry out of public economics – but Jim often managed this feat. And not least in his titles.

Accordingly, on this occasion I have given some thought to the title of my remarks, and I want to spend a little space defending my choice.

First of all, as is probably widely known, 'onwards and upwards' is one of Buchanan's standard ways of signing off letters. In that sense, it is a kind of Buchanan 'signature', as we might put it. More than 'cheers' or 'best wishes' or any of the other standard exits, 'onwards and upwards' has always struck me as both more communicative and more engaging. It speaks of pressing on, with confidence and a sense of purpose and destination. Indeed, I have been so impressed with the phrase that I have presumed to adopt it myself – just another of the many things that I have taken up from the Buchanan repertoire. And I notice that I am not unique in this – that several others of the extended Buchanan intellectual family use the expression as well. To my knowledge, none of these others refers to "life in the putty-knife factory" – an expression that is, in my experience, unique to Jim; nor, at a more intellectual level, to that distinctively Buchananesque [and, to my taste, infinitely obscure] expression, "the relatively absolute absolute". I was actually tempted to title this piece, 'Life in the Putty-Knife Factory' and indeed may well save that title for another occasion; but I can assure you that the 'relatively absolute absolute' was no temptation at all. There are some things that only Buchanan himself can do!

So, 'onwards and upwards' it is.

## II. But Is It Descriptive?

As a title, though, it needs more extended defence. As Buchanan has taught me, good titles need to be not only *associated* with their subject matter, but also actually descriptive. Does this title qualify? After all, here we are celebrating Jim's 80<sup>th</sup> birthday. And just a matter of weeks ago, he formally retired from full-time *paid* work here at George Mason – signifying, if not a closure [in fact, surely not a closure] of a career for which no superlative seems adequate, then at least for most normal folk something of a winding

## ONWARDS AND UPWARDS

down. And have Liberty Fund not, over the last few months, published the first four volumes of the twenty volume Buchanan collected works? Doesn't that rendering of the whole Buchanan corpus suggest that ... well, that it IS pretty much the whole Buchanan corpus? In short, though there may well be a little more "onwards" in the Buchanan career, doesn't it rather strain the imagination that there could be much more "upwards"? "Onwards and *downwards*" would surely be no disgrace, given that the start is from such stratospheric heights. And wouldn't that, in all candour, be a more apt title?

It perhaps goes without saying that I wouldn't raise this question – at least in the present context – if I did not think it could be satisfactorily answered. So let me offer some relevant observations.

On the face of things at least, "onwards" presents no real problem. Indeed in a sense, onwards is unavoidable. As Jim has often remarked about the authority of the status quo in assessing the desirability of change, we have no choice but to go from where we are. If that expression is rendered with the emphasis on "go" rather than on "from where we are", then it becomes: "we have no choice but to GO from where we are". And that observation seems no less right to me. There is a kind of inevitability about moving on, however much we might sometimes prefer that things would stay put.

There are, however, some notable features of Buchanan's particular 'onwards'. Recently, I was looking at the 1980 Annual Report of the Public Choice Center – then located in the pleasant environs of the President's House at Virginia Tech in Blacksburg – and looking in particular at the photographs of the usual suspects – Bob Tollison, Gordon Tullock, Jim Buchanan, David Levy, Dwight Lee, and myself. I was struck – though it should have been no surprise – by how much we had all changed in the last twenty years. Tollison for example looked a bit like the young Che Guavara – all wild hair and bushy mustachios; Dwight Lee looked about sixteen; I was almost unrecognisable. But Buchanan's appearance had hardly changed at all. And it is not just the appearance that has remained constant. During my most recent visit to the Buchanan House a few months ago, Buchanan was in residence the entire time [as distinct from being off on one of his extended academic trips, of which more anon]. I can report that he is still putting in his 6:20 am to 5:20 pm days every day of the working week and all day Saturday, and even three or four hours on Sunday morning. [I have it on good authority that he would stay longer on Sunday if it were not for the fact that doing so would expose him to the temptation of doing serious damage to some of the worshippers at mid-morning mass in the church over the way;

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these folk seem to believe that their religiosity gives them licence to park anywhere they like, including in the Buchanan House parking lot, thereby blocking the departure route. My guess is that said worshippers simply cannot imagine that anyone at George Mason would actually be at work on Sunday mornings. But in this respect as in so many others Jim is unusual]. He can still astound you by having comments on the paper you just gave him, typed and back in your in-tray almost before you've got back settled in your office. And he's still passing on interesting new books [many of them suggested by Frank Foreman] or articles in the most recent TLS. When I was there last, he was negotiating an extremely technical piece in a recent issue of the AER, which connected in some way to his current enthusiasm for the commons and anti-commons. Buchanan has never seen himself as a mathematician but he still labours long and hard over the journals.

He is still, of course, publishing at a rate that makes the rest of us feel decidedly inferior. And he maintains a travel schedule of quite daunting proportions. He seems to travel to Europe or South America about ten times a year, to say nothing of the regular trips to American universities, and participation in professional Meetings and the occasional Liberty Fund conference. All of this, interspersed with the routine commute backwards and forwards to Blacksburg, where he still spends about a third of his time at his 'country estate'. A couple of years ago, he wrote to me about a particular trip, confessing that he was going to have to wind back his travel. The trip in question as I recall involved going first to South America, then back to Texas, and from there on to Europe [I'm not sure whether it was Italy or Germany or both] – about three weeks away all up. Somewhere along the line – on the leg to Texas as I remember – his luggage got lost. And then in Europe he fell ill with an infection of some kind. One might think that an experience like that would cure him of travel altogether. After all, if you travel at the rate Buchanan does, the law of averages will land you with a disaster trip occasionally. But Buchanan seems to have exploited this reasoning to reach precisely the opposite conclusion – namely, that this particular trip was just a statistical outlier and gave no reason to expect any similar experiences in the future. So, with a few modifications, he is now back to his old travelling tricks. "Onwards" indeed.

Recently I myself turned 55. This is the age at which many of my local contemporaries start to think about retirement. It is the minimal age at which one can opt to take out your retirement pension; and some few do. Those that do not, certainly begin to think about it. All this tends to make you feel old; it

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makes you think that other people *expect* you to feel old. It's all a bit depressing. So I do occasionally call to mind the fact that when I first went to the Public Choice Center in 1976, a mere 23 years ago, Jim was then a couple of years older than I am now. When I think of all that Buchanan has accomplished in those 23 years, it makes it seem ridiculous to feel old or to imagine that anyone *should* feel old at 55. For me at least, the thought of Buchanan at 57 is invigorating – indeed, inspirational – to one of a mere 55 summers. Of course, Buchanan is in this respect exceptional and no reasonable person could hope to emulate him. But if I am as energetic and active at 60 as Buchanan is at 80 I shall be content.

"Onwards" connotes, of course, more than mere motion. It involves movement *forward*, with intent and purpose, with commitment, even a certain inexorableness. That too is an essential piece of the Buchanan character. And can be illustrated by appeal to a personal anecdote. Buchanan and I were travelling together to the Western Economic Association Meetings in San Francisco. As we were taking off, Jim complained of a slight ear-ache. I immediately offered him a piece of chewing gum – a well-known remedy for air-pressure disturbance; but this he politely declined. "Chewing gum gives me a head-ache", he explained. "Oh?" says I. "Are you allergic to something in the gum? That's interesting; I've never heard of anyone else having such an allergy." "No", replies the great man, "no allergy. It's just that when I get the gum in my mouth, something makes me try to grind it to a pulp; and all that relentless chewing gives me a head-ache." Instructive, that, I thought. There is something of that same utter commitment in the approach to his work – a quality that borders on the compulsive and indeed would appropriately be describable as compulsive if the attribute were not in part self-conscious, and ethically grounded. It is not for nothing that an important theme in Buchanan's academic work – particularly in the early 90's – has been the 'work-ethic', and how that ethic might be lifted from the level of mere intuition [which in Buchanan was doubtless strong] to the level of systematic justification within the contractarian normative framework that Buchanan has done so much to refine and promote. It is not just chewing-gum that figures here. Buchanan has, for example, a deep suspicion of intellectual games like bridge and chess; he sees such pursuits not just as distractions from one's work, but as potentially *addictive* ones – arenas like chewing where one's natural propensities towards focus and commitment could easily take over. He reckoned bridge at lunchtime in the Public Choice Center to be a serious and dangerous



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matter; and he disapproved, I suspect, precisely because he could see its attractions.

I don't mean to imply by these observations that Buchanan is a dull dog – all work and no play. In fact, the distinction between work and play is to miss the point. Buchanan's work is something he does essentially for its own sake as a kind of mental sport; and he has too much imagination to lack a sense of humour, not least about himself. But there is also a steely sense of purpose there – a level of commitment that is extraordinary, and for those of us who share his work ethic intuitions, exemplary.

So, as I say, "onwards" seems unproblematic – even inevitable. And certainly an intrinsic feature of the Buchanan personality.

### **III. But what of "Upwards"?**

It would of course be possible to deal with the "upwards" aspect of the title in the same spirit as we have treated "onwards" – that is, by reference to attitude rather than trajectory. Existentially rather than objectively, as it were. Certainly, one cannot long go on in any creative enterprise, of which academic life is one, without the sense [the illusion perhaps] that one has yet more to say, more to add to whatever one has accomplished to that point. Onwards more or less requires upwards attitudinally. And few will doubt that Buchanan still has lots of interesting and novel things to do and say. He has a long history of surprising us with new ways of thinking and new insights about things that cause us to reassess matters we thought we pretty well had understood. It would be amazingly against the trend if Buchanan did not continue to surprise us, though of course it is in the nature of surprise that we shall, when it happens, be... well, a bit surprised.

Of one thing we can be reasonably sure is this. And that is that the surprise will come in a new area. Buchanan is not one of those scholars who goes back and reworks previous stuff. Indeed, he is a bit profligate with his creative offspring. Once they are produced and released into the public arena, he seems to have little interest in how they are being received – still less in defending them. I can recall a few occasions on which would-be critics have thought that they had a decisive argument against some current Buchanan proposition by reminding Jim that on some page of some earlier work, he had seemed to say the precise opposite. Buchanan would often confound such

## ONWARDS AND UPWARDS

critics by the response: "so what?". He was never inclined to regard his own earlier remarks as authoritative: he always demanded an *argument* not a reference – and references to the younger Buchanan carried for him no more weight than references to anyone else. He almost entirely lacks that narcissistic element that many scholars seem to have in going back and reading and rereading his own stuff. It is said of Edward Elgar in later life that he was only ever interested in listening to records of his own compositions; I am reasonably confident that Jim would regard a continuous reading diet of the Buchanan collected works as a form of torture. Not that he is not delighted, I know, to have the Collected Works published, but this for a different reason to which I shall shortly turn.

There is then no problem about "upwards" as a description of Jim's posture to the future. But after fifty years of scholarship at a level *so* elevated that almost any description is bound to seem inadequate, a level of accomplishment such that there are no more accolades to be won and no prizes or positions left to be sought, after all this, isn't "upwards" a little strained? What else, we may ask, is left?

There is a Buchanan story that bears on exactly this question. The story revolves around a question Jim would occasionally pose to a candidate being interviewed for a position, or in a tenure decision process. The question is in the form of a Shakespearean riddle, redolent of the one in *The Merchant of Venice*. You have three choices. They are by assumption mutually exclusive. The first is that in five year's time, you can become for a year *the guru* of the economics profession. Your views will be sought by presidents, and your comments by the press. By common consent, you will be regarded as the most influential economist of your time. And you will be! For a year. That is the first option. The second is that in thirty years you will win the Nobel Prize for economics. The third option is that in two-hundred years, historians of thought will look back and say that, at this point in the history of economics, you[X] were doing extremely significant and interesting work—the most important work, perhaps, of your time. Bearing in mind that these are mutually exclusive options, which do you choose?

It was a good puzzle. Some candidates would interpret it as an exercise in discounting and take it that the earliest option must be best. Others would think of it as an exercise in convexity and take the middle option. But for Buchanan there could only be one appropriate answer – the third. Those who chose the third were, he thought, the true scholars – those who know what the real game is. Of course, there were other aspects to this. Buchanan has no

## GEOFFREY BRENNAN

taste himself for the first option and does not much approve of those among his professional colleagues who seek that role. He will often remark that he himself has no desire to shape the world; and his view seems to be that those economists who do get themselves into positions where they *can* shape the world generally do more harm than good. Moreover, he is mistrustful of institutional arrangements that provide scope for *anyone* to have much influence on the lives of others. As far as I know, he bore no particular animus to the Nobel Prize in those days before he won it. Nevertheless, it remains clear that, as he sees it, even awards of that distinction are not the main game. At best, the Nobel Prize is to be seen as an incidental consequence of aspiring to something bigger and more worthy – namely, posthumous recognition. Given the structure of the puzzle, it is perhaps ironic that Buchanan has won already what he regards as the lesser prize, but of course, the options are mutually exclusive only in the example and we should not take our examples too seriously.

What I take from this story is that there *is* something more that Buchanan aspires to – something more or less objective to which the "upwards" of the title can properly refer. And I want to turn now to a consideration of what this particular understanding of "upwards" involves.

There are three aspects of interest here. First, what kind of a picture of intellectual progress does this aspiration involve? Secondly, what, if anything, does the aspiration imply behaviourally? Thirdly, what pieces of the Buchanan intellectual contribution seem most likely to satisfy the posthumous recognition test?

### IV. Implications of "Upwards"

#### 1. The Nature of Economic Enquiry

What does the ambition of posthumous recognition imply about the nature of economics and the many related disciplines into which Buchanan has strayed over the last fifty years?

As far as Economics is concerned, it is common to distinguish two pictures of the discipline – one borrowed loosely from science; the other traditionally associated more with the humanities. The self-styled scientific one holds firmly to a view of more or less linear progress in the "accumulation of knowledge"; the model is one of an ever expanding stock, with limited [if

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any] depreciation. Within this model, mistakes can be made but the conviction is that the processes of empirical investigation will eventually weed truth out from error, and that what is worth knowing will eventually be absorbed into the corpus of knowledge. This model carries with it a particular view of the discipline's history – namely, that though as a kind of biographical exploration of the trials and tribulations of previous generations of scientists, as an exercise in the identification of heroes and accumulation of role models, looking at the work of earlier generations of scientists can serve a useful function, it is not itself a crucial piece of the actual practice of the science. The history of physics may be interesting, but it is not itself physics.

Contrast this view with what I have here called the 'humanities' view. On this view, the idea of intellectual *progress* as such is much more ambiguous. I choose the word "ambiguous" here advisedly. I want explicitly to reject a picture in which there is no *possibility* of progress; for if there is no capacity for progress there is equally no capacity for genuine error. The idea that conceptions of truth and falsehood have no place in enquiry, however fashionable it may be in certain circles, seems to me to be a serious mistake. What we might loosely term the 'post-modern' mistake. The 'post-modern' view, as I understand it, makes enquiry out to be an essentially aesthetic pursuit, in which truth becomes indistinguishable from what makes a good story [with "good" here often enough understood in terms of "what is in the author's interests"]. In the proper 'humanities' view, as I construe it, there *is* genuine truth and falsehood, real insight and real blindness, and a continuing threat of *forgetting* truths that have been previously known. It is this picture, I think, that goes with the ambition embodied in Jim's third option. Because this is a picture that accommodates not just a kind of antiquarian interest in famous economists of the past but a genuine engagement across time with the minds of fellow travellers. It is not too unfamiliar an experience, in Buchanan circles, to be reading Adam Smith or David Hume and to come to the conviction that "we've got this all wrong" – that some proposition that is currently a plank of orthodoxy and which colleagues confidently assert as "something we now know" is actually misconceived. One of the lovely quotes I have learned from Jim is that wonderful one-liner of Josh Billings: "It ain't so much the things we don't know as hurts us, it's the things we do know that jest ain't so". That ought to be one of the prime texts of the economics profession I reckon. It is in the same spirit as that wonderful line from Aristophanes [*The Birds*] that goes: "Let your intellect roam free – like a cockroach on a leash!"

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My point here is that somewhere between the model of enquiry as a confident linearly progressive march into greater and greater truth and the model of it as the mere self-indulgent play of over-imaginative minds, there is a middle ground – a picture of enquiry as a precarious and tentative enterprise, where progress is possible but is hard-won, where attractive and plausible errors lure from every side, and where one of the greatest of such errors is condescension towards the past. Of course, we don't want to reify the past either. Nevertheless, it is, to me at least, an invigorating thought that we join with Smith and Hume and Edgeworth and Marshall, as well as with contemporary scholars, and indeed with those yet unborn, in a common enterprise where all enter across time as more or less presumptive equals. If one has this picture, it is certainly a natural desire to be a recognised player in that game. And that is how I read the third answer to the Buchanan riddle.

Now, I should be careful here not make Buchanan the mouthpiece for my own particular prejudices and conceptions. Buchanan's sometimes radical subjectivism does occasionally lead him to espouse views that stray closer to the post-modern end of this spectrum than I would think appropriate. But it seems to me that something of the middle ground that I have outlined is the only picture of enquiry consistent with Buchanan's stance on his own riddle – and for that matter offers the most accurate account of economics and its near disciplinary neighbours. How else, after all, is one to give a satisfactory account of the young Jim Buchanan in the stacks of the University of Chicago Library in the late 40's, taking down the apparently forgotten Wicksell habilitation thesis – and recognising there a primitive version of his own intuitions, the working out of which will come to represent a huge part of the Buchanan intellectual enterprise? How else can we give an account of the still young Buchanan recognising, in a flash of inspiration after some months of study as he strolls down the stairs in the Hotel Angloterra in Rome, that the apparently quaint position which the Italian public finance scholars had taken on the incidence of public debt was actually right – exactly against the confident orthodoxy of the time. It was this insight that generated what I think of as Buchanan's first big book, *Public Principles of Public Debt* – which still stands as one of the most elegant clear-sighted accounts of the public debt incidence question. Both the Wicksellian and the Italian experiences in the Buchanan story speak to me of intellectual insights lost and then regained, of dominant professional errors that one has to struggle long and hard to overturn. These experiences require a picture of the nature of intellectual enquiry that will accommodate them – indeed, not just accommodate them but make

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them central pieces in the whole conception of what it is that we academic economists are about.

### 2. Behavioural Implications

Suppose we adopt this conception of the nature of enquiry –at least in the areas of academic territory we call our own. And suppose that you, as a young aspiring academic had happened to answer the Buchanan riddle in the right way. What would this aspiration imply for the way you conduct your intellectual life? It certainly might encourage you to read more Adam Smith. Which would doubtless be no bad thing. But what of the shaping of your research agenda? Does this riddle help us to understand what Buchanan himself thinks about as he sits down to write on of his classic pieces? I suspect not. Or not much anyway. In fact, I doubt that *anyone* sets out in their career, picking up the pen to start on the very first paper, with the ambition uppermost in the mind of writing something that will be remembered a hundred years hence. And I am by no means sure that it would be a good thing if one did. I suspect that most of us are driven primarily by a desire to get something sorted out in our own minds, by a desire to play the academic game more or less for its own sake and perhaps, in the process, to persuade others (usually significant others like one's dissertation supervisor or some major figure in the field) that one *can* play that game and play it well. Whenever we write anything, it is I suppose with some audience vaguely in mind – some group or person that we want to impress with our cleverness or our erudition. But often enough, that audience is not uppermost. What is uppermost is just the game itself – the sheer enjoyment of coming to terms with ideas, of discovering that what you more or less thought before isn't quite right and indeed may even have been wildly wrong. Indeed, doing a bit of introspection myself, it is an interesting challenge to give an account of who I write for. That there is *some* imagined audience I have no doubt. But I am by no means sure I can identify exactly who it is. What I *am* reasonably sure about is that that imagined audience is not specifically composed of Adam Smith and David Hume or Alfred Marshall – and as for me, so I suspect for most of us. If posthumous recognition plays a role in our motivations, it is not because we want to impress our long-dead ancestors. Nor, though this is more plausible, that we want to impress our as yet unborn descendants. Indeed, it is something of a puzzle what role the desire to be read in a hundred years actually plays in the immediate arena of intellectual action. Yet it must play *some*

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role in behaviour, because otherwise it is difficult to see why Buchanan would be interested in securing this particular answer to his riddle.

I am inclined to think that this puzzle is an instance of a more general question in economics – that concerning the connection between motivation and action. And I want to spend a bit of time exploring it.

In economics generally, and particularly in the area of institutional design or 'constitutional political economy' as we might call it, we are used to making a distinction between motivation and justification. That distinction is, for example, crucial in the analysis of invisible hand mechanisms. What is taken as the primary motivation of agents in the marketplace is self-interest: what drives me to act is that the expected outcome is good for *me*. But what *justifies* the outcome or pattern of outcomes that emerge from the market is that it is good for *us*. It is the 'hand' aspect of the invisible hand that justifies; but the reason why there is something to be said for its achieving its benign outcomes 'invisibly' is because the desire to produce benign outcomes as such is rather weak. If all were angels, as Madison [almost] put it, we wouldn't need the market system and/or a publicly enforced system of private property to undergird and support that system. But angels are scarce. The genius of invisible hand processes is that they achieve good outcomes without requiring that the agents who produce those outcomes are particularly benign or indeed particularly *concerned* with the overall goodness of the outcomes that emerge.

As I say, this distinction between motivation and justification – or what we might otherwise describe as the causes versus the reasons for action – is familiar to us. Indeed, so familiar that we often draw the distinction excessively sharply. My guess is that for most people justification as such plays an important background role in their behaviour and does exercise its effects at the margin. The truth of the matter is that precisely because we operate most of the time within institutions that have a substantial 'invisible hand' character – in contexts, that is, where the conflict between doing what is best for us and doing what is best for others is limited – motivation is over-determined. We simply cannot tell whether the butcher produces first-class meat out of a benign feeling towards his customers or a pride in good butchering for its own sake or in order to maximise his income. Almost certainly all of the above in some measure. We might conjecture that the butcher would not long continue in his occupation if the income from it disappeared. But then he might well also shift his activities if it came to be widely regarded in the community that butchery was an evil occupation, associated with the inflict-

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ing of terrible harms on innocent animals. Of course, if this particular view did come to be a widespread, then many people would presumably eat less meat and so the butcher's income would decline. In which event, an income-based 'explanation' would be empirically supported, even though the motivation in play was not itself income-related. Part of the force of the observation about over-determination is that empirical evidence cannot decide the matter.

Or consider a different case, somewhat closer to home. We, being academics, are inclined to think that intellectual life is a good thing and that more people should be exposed to it and that those who are talented at it should be provided with opportunities to pursue it more extensively. Accordingly, academics are inclined to vote for parties and candidates who promise more money for universities. An observation to this effect can be identified as evidence of pure self-interest – since as academics we are likely to benefit individually from an increased demand for our services. But this self-interest aspect may play little role in the psychology of individual voters; and your academic colleagues may feel aggrieved if you describe their conviction about the value of the life of the mind as mere demonstration of naked self-interest. Often of course self-interest has a secret life precisely because to be seen to act from self-interest is to invite disesteem – whereas to act from nobler motives is to invite the general esteem of others [and for that matter oneself]. Where acting morally and acting self-interestedly are not too much in conflict, it will be rational to adopt moral dispositions in the arena of action if you have a desire to be thought well of by others [and for that matter by yourself]. The desire for esteem, in other words, means that in invisible hand societies – societies, that is, where most of the important contexts are such that self-interest and public interest are reasonably closely correlated – publicly interested dispositions will tend to flourish. It may be thought, particularly by those with a Mandevillean cast of mind, that this flourishing reflects a form of hypocrisy. There is, after all, a real sense in which an important part of the *reason* why agents act out of moral considerations is that it does not cost them too much to do so. But that observation is not itself enough to show that the moral motivations are insincere. It may well be the case that what operate as the primary motivations in the arena of action are considerations like professional integrity, or public responsibility; and in particular, that a picture of the agent as acting out of those considerations is more psychologically descriptive than a picture of agent as *homo economicus*. But matters of self-interest may still play a crucial *explanatory* background role as totally indispensable 'psychological reinforcement'.



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How does all this bear on the Buchanan riddle? Well, I do not believe that an ambition to be read in a hundred years time explicitly enters into Buchanan's mind when he sits down to write a paper. No more does the desire to win the Nobel prize – either for Buchanan in his pre-prize days or for most of the rest of us. Such ambitions might serve for many as a kind of vague fantasy – just as the prospect of playing in the World Series fires the hopeful imagination of every sandlot player. But for most of us, most of the time, what is in the forefront of our minds is the sheer intellectual pleasure of playing with ideas, of sorting out some puzzle just because it is a puzzle. Nevertheless, those things that justify the activity do hover as causal influences somewhere in the background. They may not come into play in many cases; they may indeed only operate counterfactually in the sense that they would come into play if the motivation of sheer intellectual pleasure led you to do things that would fail to be justifiable. For example, in that background role, the Nobel Prize for economics probably serves to dignify the profession, to recognise our heroes and thereby establish salient role-models for the rest of us. The point is that these background influences may shape behaviour, may raise the calibre of entrants into the profession, and may even colour scholars' research agendas – even though those influences are not explicitly entertained as reasons for action, still less as the sole determinant of a research agenda, for any of the actual players. The possibility of posthumous recognition seems to me to fit that role – it is a factor that may play a critical shaping role, but mostly quasi-subconsciously.

In a way, the precise advantage of posthumous recognition is that there is not much one can do to bring it about. That may, for all I know, be part of its attraction for Buchanan. In my experience, Jim has a healthy mistrust of public adulation – not least because of the effects it often seems to exert on the adulee. Still, if there is not much one can do to ensure posthumous recognition, there is plenty one can do to make it virtually impossible. Becoming preoccupied with little technical puzzles, or focussing attention exclusively on immediate policy issues, or just not doing much of anything. If one seeks to join the conversation with the great minds across the centuries, not as an exegete but as an aspiring participant, one had better think on a big canvas. And you had better not be content with showing how clever you are: something more than mere native 'smarts' will be required.

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### 3. But what of Buchanan's Work Will Survive this Test?

At the most general level, it seems clear that Buchanan has got the problem of maximising the survival chances of his ideas pretty much right. He has worked on big questions and with an agenda that is large in scope and compass and that is identifiably and distinctively his own. It seems unlikely, for example, that public choice economics, or "rational actor political theory" as it is coming to be known, will ever entirely disappear from the intellectual landscape, whatever happens. The field may be co-opted by the technocrats. It may be taken over by the New England academic establishment in such a way that Virginians gradually diminish in the citation lists to be replaced by a more recent set from more fashionable stables. There is already some signs of these developments. But I think such considerations are of more relevance to second generation Virginia School scholars than to Buchanan himself. Likewise, constitutional political economy seems set for a continued life; and though that area of enquiry may be more and more connected with political philosophy [and political philosophy more connected with it] the academic habits in political philosophy of honouring and engaging the great minds of the past seem likely to ensure that Buchanan will still be read and argued over a century or so hence.

There are, however, other aspects of Buchanan's thought – no less central in the whole Buchanan intellectual scheme – that might have a harder time of it. The subjectivist element, for example, which seems possibly too sparing of positive results to endear itself to economists across the board. It is hard for scholars to admit that they do not and indeed cannot know the answers to a range of questions that other scholars in the same field do profess to know. Genuine subjectivists will, for this reason, probably always be a kind of prophetic minority in the economics profession.

Likewise, possibly, Buchanan's contractarianism. There is, it seems to me, a strong tidal pull in economics towards consequentialism – indeed towards utilitarianism, often of a rather crude kind. And though simple 'economic utilitarianism' has taken quite a few knocks as a normative scheme this century, consequentialism of a broader kind does seem to be enjoying a revival in economics, even in those areas which are most inclined to be philosophically self-conscious. Part of the difficulty here lies in a tension evident in Buchanan's own work. In some places, the contractarian scheme seems to play the role of a conceptual test attempting to indicate what could plausibly be agreed by a community of more or less rational individuals. In other

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places, the possibility of such an interpretation is overthrown by the limits Buchanan places on what can plausibly be known. It is impossible to predict what can be agreed if nothing at all can be known about the content of individuals' preferences/values. Here, only actual agreement can provide any sort of ethically compelling contractarian test, and apart from insisting on unanimity (at the relevant constitutional convention stage), it is not clear what of any use further normative analysis can add.

Of course, the question as to what ideas will survive and flourish over a horizon even of twenty years, let alone a hundred, is a matter of total speculation and it would not be sensible to hazard more than the most tentative conjectures about it. I am certainly not saying that the subjectivist and contractarian elements in Buchanan's thought do not *deserve* to survive, or that they are not critical pieces in the whole Buchanan intellectual scheme. Indeed I rather think the opposite. The point I seek to make is that the desire to have one's work survive does not in Buchanan's case determine or much shape the agenda – and still less the content of Buchanan's writings. One wants to be heard – but not because one slavishly delivers the message one thinks the audience wants to hear. Posthumous recognition can work as a *reward*, perhaps even at an appropriately abstracted level as an incentive, but it cannot plausibly work as a motive in the arena of action. At the keyboard, it's just a matter of saying something that is, first of all, *right* and second, *interesting*.

Let me try to summarise. My object in this discussion of the Buchanan riddle has been to explore briefly three matters: first, what I think this riddle implies about the nature of economic enquiry; secondly, what role if any the possibility of posthumous recognition properly plays in academic life, and what kind of influence it has exercised in the Buchanan case specifically; and thirdly, what pieces of the whole Buchanan scheme seem more likely (and what pieces less likely) to satisfy this recognition test. In the process, I have been led to offer some general remarks about motivation in rational actor social analysis, and to gesture at the causal role that certain 'demand-side' influences may play even where they do not figure significantly in the actor's conscious deliberative processes.

It is tempting to observe at this point that how much, and precisely what, of the Buchanan contribution is flourishing two hundred years hence, depends less now on Buchanan himself and rather more on us. Not that we should be, or need to be, self-conscious promoters of Buchanan's ideas. [Though I cannot refrain from noting at this point that the Buchanan Collected Works project, graciously advanced by Liberty Press, will serve to

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make available those ideas in a neat and highly accessible form – and not only for the present generation]. But for the most part, the Buchanan legacy is there in our intellectual genes, probably well beyond our consciousness of it. I have in mind here nothing much more than our determination to stay active and to do the best work of which we are capable. That and the confidence to imprint our students with the characteristic Buchanan virtues – utter commitment, a love of ideas rather than fancy tricks, and a desire ultimately to engage with large, serious questions with scholars beyond one's own blinkered time. This done, Buchanan's ideas can be safely left to look after themselves.

### V. The Personal Legacy

There is of course another dimension to any academic's legacy – that is, the influence, outside the written work, on students and colleagues. Any student of Buchanan's [ which I am not – at least in any formal sense] cannot help but be aware that he /she stands in a long tradition of distinguished scholars who all share that feature. All of these will have their own stories to tell about the experience of Buchanan as teacher. I *can* speak of Buchanan as colleague – but again as only one of a large number, all of whom carry with them something distinctive that they owe to Jim.

I want to record three things from my own experience here. First, Buchanan is an extremely generous person to collaborate with. I have, over my career so far, been involved in a large number of co-authorships. Some of these have been pretty tricky. Often scholars do not like their deathless prose changed; often, they become absurdly committed to their own little spin on an idea. I confess to these inadequacies myself. Buchanan is remarkably relaxed on these fronts. Not only is he not obstinate about his own drafts – but he is remarkably generous-spirited about his co-author's drafts as well. This is not to say that he is uncritical. Entire chapters have on occasion had to be jettisoned – almost invariably for what I later came to realise were excellent reasons. And any co-author will recall certain grammatical strictures like the distinction between "between" and "among", or the objection to the unattached "this". And stylistic rules, like his antipathy to "Thus". He was quick too to expose sloppy exposition or confused reasoning. But he was quite tolerant of all those stylistic eccentricities which sadly abound in the Brennan

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prose. Writing with Buchanan was a remarkably easy as well as instructive experience.

Second, Buchanan is a wonderfully generous colleague in another way. I would often appear in his room with a half-baked idea or give him some half-worked out notes on something I had been thinking about. He quite routinely would think for a while – and then say: "you know, that's interesting, really interesting". Of course, what was interesting about what was before him was what he had made of it in his mind – leaping forward to implications I had not foreseen or to reformulations that I had not even imagined. The point here is that younger colleagues find that sort of response intensely affirming. Being disposed to find one's colleague's work interesting is one of the most valuable attributes you can cultivate in becoming yourself a good colleague. This is a lesson I have learned from Jim Buchanan; and I regard it as an important lesson.

I am reminded in this connection of an occasion very early in my initial spell in Blacksburg. I was visiting with my wife and young family including Michael my son then aged five. Buchanan and I and Mark Crain had participated in a local television interview on tax reform; there was a studio facility set up by VPI on the campus for the purpose of getting a little exposure for the academic staff. The broadcast was some days later about six in the evening; and all the family foregathered on the parental bed to watch Daddy on the TV. [For some reason, the TV was in the main bedroom]. The interviewer settled on me first; and after I had delivered myself of a few remarks on the subject, the interviewer turned to Professor Buchanan and asked: "And what do *you* think, Mr Buchanan?". And Jim responded: "Well, I agree with Geoff here". Whereupon Michael turned to look at me wide-eyed on the bed and said with total awe: "Daddy, Daddy, Mr. Buchanan *agrees* with you!" One of the great moments of my life! As we get older, it becomes harder and harder to impress our children. Michael was impressed that day – and rightly so. If I ever write an academic autobiography in the style of Jim's 'Better than Ploughing', I fancy that I might give it the title: "Mr Buchanan *Agreed* with Me". I was talking earlier of titles: this one seems to me to have much promise.

There are more Buchanan-Brennan stories that might be told. Our occasional huge battles about organised religion, for example. Or our exploits of endurance with Hartmut Kliemt, in the great Blacksburg blizzard of 1993! What is important about all of those stories, I find on reflection, is that they reveal in different ways what a great and generous colleague Jim is and has

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always been to me. And what a huge influence in so many incalculable ways. I am in this sense typical, I believe, of all those who have had a personal association with the man. Students, colleagues, friends – whatever the precise connection – we have been privileged to rub shoulders with the great! And that experience has greatly enlarged our lives.

### VI. Conclusion

There has been a poem that has vaguely hovered in the back of my mind as I have written this talk. It is a piece of Tennyson – not normally my favourite poet. But this poem has struck me as apt for three reasons. First, there is an explicit Australian connection. Although it is not widely known –even in Australia – Tennyson's eldest son was Governor of Australia in the early part of this century (1903-04, to be precise, after being Governor of the State of South Australia for some years previously). Secondly, the poem deals with Ulysses who, as most of you will know, adorns the front of the journal Constitutional Political Economy as the logo appropriate for the analysis of institutions [ a reference to Ulysses' negotiations with the Sirens]. And third, the poem is constructed around the idea of an ongoing quest – one that might well be interpreted in intellectual terms. In this poem, Ulysses is old. In the most general terms, it speaks to the question of how to deal with age. The poem has a distinctly stoic quality; it calls for continued journeying without illusion – what we might loosely think of as "onwards without romance"!

I shall not quote here the entire poem. It is rather long. But the excerpts I have taken are long enough to give you a flavour of the poem's spirit and a sense perhaps of why it has struck me as appropriate.

[fragments from] Ulysses  
by Alfred Lord Tennyson

"... I cannot rest from travel: I will drink  
Life to the lees: all times I have enjoyed  
Greatly, have suffer'd greatly, both with those  
That lov'd me, and alone; ..  
...I am become a name,  
For always roaming with a hungry heart;  
Much have I seen and known; cities of men

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And manners, climates, councils, governments, myself not  
least, but honoured of them all;  
And drunk delights of battle with my peers  
Far on the ringing plains of windy Troy....

How dull it is to pause, to make an end,  
to rust unburnished, not to shine in use!  
As though to breathe were life. Life piled on life  
Were all too little, and of one to me  
Little remains: but every hour is sav'd  
From that eternal silence, something more,  
a bringer of new things; and vile it were  
For some three suns to store and hoard myself,  
And this gray spirit yearning in desire  
To follow knowledge, like a sinking star,  
beyond the utmost bound of human thought.

...Old age hath yet his honour and his toil;  
Death closes all: but something ere the end,  
Some work of noble note may yet be done,  
not unbecoming men who strove with Gods.

... Come my friends,  
'Tis not too late to seek a newer world.  
Push off and sitting well in order, smite  
the sounding furrows; for my purpose holds  
To sail beyond the sunset, and the baths  
Of all the western stars, until I die.

...Tho' much is taken, much abides; and tho'  
We are not now that strength which in old days  
Mov'd earth and heaven; that which we are, we are;  
One equal temper of heroic hearts,  
Made old by time and fate, but strong in will  
To strive, to seek, to find, and not to yield."

Or, as Jim himself would say, "onwards and upwards"!

## 2 Buchanan and the Virginia School <sup>1</sup>

ROGER D. CONGLETON

- I. Origins of the Virginia School
- II. The Intellectual Enterprise: Constitutional Political Economy and Public Choice
- III. The Network of Students, Colleagues and Fellow Travelers
- IV. Buchanan and the Future Virginia School

**Abstract.** In the second half of the 20th century, the Virginia school of political economy has emerged as an important research program that explores the boundary between law, economics and politics. Although that research program is now carried out by many prominent economists and political scientists around the world, the work and personality of James Buchanan has always played an important role in its development, and in its appeal. This paper attempts to characterize the relationship between Buchanan and the Virginia school. It is written to honor his eightieth birthday.

### I. Origins of the Virginia School

Determining the origins of a school of thought is very much like finding the headwaters of a river. The river is obvious, as are its antecedents in rainfall and topography, but no clear beginning can be identified. A single rain drop or spring can never by itself create a river, and yet far up in the moun-

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1 The brief overview of the Virginia school presented here reflects my observations as a student, graduate, visitor, senior research associate, and, very recently, general director of the Center for Study of Public Choice. It is clearly influenced by a variety of conversations over the years with Charles Goetz, Robert Tollison, Dennis Mueller, Gordon Tullock, Richard Wagner, Mark Crain, Charles Breeden, Mark and Genia Toma, and, of course, James Buchanan to name just a few that come quickly to mind.



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tains it may be asserted that "the river begins here." Such is also the case with the origins of the Virginia School of political economy. Its fundamental ideas and research program could easily be given Swedish, Italian, Scottish, or Greek origins, yet the river that emerged at the end of the 20th century first began to take a clear form at the University of Virginia in the 1950's and 60's in what may be called, with some exaggeration, the Buchanan era.

As chairman and one of the major intellectual wellsprings of the economics department at the University of Virginia, his impact on hiring, on visitors, on students, on seminar speakers, and on the course of research was obvious. It was here that Buchanan's contractarian view of public economics was worked out. It was here that Tullock's work on bureaucracy, voting, and rent-seeking received support and stimulation. It is here where such graduate students as Charles Plott, Richard Wagner, Charles Goetz, Mark Pauly, and Robert Tollison studied and launched their own intellectual enterprises. It was here that the link between political decision making processes and political institutions were clearly articulated by Buchanan and Tullock in the *Calculus of Consent* (1962). It was here that NSF sponsored meetings focusing on non-market decision making were first organized.

Of course, the work at Virginia did not take place in an intellectual vacuum. Other related and important strands of research were being undertaken by such energetic and creative scholars as Mancur Olson, William Riker, Anthony Downs, Duncan Black, Albert Breton, Frederich Hayek, George Stigler, Ronald Coase, and Douglas North, to name just a few of the "non-Virginia" scholars whose work influenced or contributed to the flow of Virginia Political Economy as it emerged as an identifiable school of thought during the 1960s and early 1970s. Indeed, the phrase "Virginia School" was not invented in Virginia, but in Maryland by Mancur Olson (1971).

In 1969, the center of gravity in the Virginia School moved from the University of Virginia to Virginia Polytechnic Institute and State University in Blacksburg where a new center, the Center for Study of Public Choice, was organized by Charles Goetz and Wilson Schmidt who capitalized on avoidable conflict and mistakes at the University of Virginia which lead Buchanan and Tullock to leave Virginia, and a bomb at UCLA which reduced Buchanan's interest in staying in California. Somehow Schmidt and Goetz persuaded Buchanan and Tullock to move to the rural college community of

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Blacksburg and help assemble a new staff to launch a Ph. D. program there.<sup>2</sup> History repeated itself in 1983 when the center moved in 1983, to George Mason University, again because of avoidable conflict, and again as an opportunity to launch a new Ph. D. program presented itself.<sup>3</sup>

In Blacksburg, the newly created Center for Study of Public Choice was staffed with a cadre of faculty interested in the rational choice models of politics along with young scholars with a market-oriented research agenda. Economic analysis was seen as a tool for explaining all aspects of life, not just a narrow professional activity. The journal *Public Choice* was founded at VPI, essentially by Gordon Tullock, who funded and edited it for many years.<sup>4</sup> (It was not until 1991 that Tullock passed the editorial baton at *Public Choice* on to Charles Rowley, Robert Tollison, and Friedrich Schneider.) The anarchy project initiated by Bush and Buchanan (and eventually edited by Tullock) along with the work of Rawls and Nozick rekindled intellectual interest in the fundamentals of governance. It was at VPI that Buchanan's interest in what might be called political philosophy and constitutional economics deepened with such works as *Limits to Liberty*, *The Power to Tax*, and the *Reason of Rules* (completed at GMU). It was here that the rent-seeking research program was given a major thrust in 1980 in a volume edited by Buchanan, Tullock and Tollison. It was during this time that the public choice society became an international academic society.

It was at VPI that many second generation contributions to what was becoming known as "public choice" were developed: the demand revealing process, the politics of Keynesian economics, the politics of taxation, the full-line forcing power of bureaucracy and extensions of the Chicago school's theory of regulation. A new group of graduate students was trained and, and again, prominent visitors attracted. Resources provided by the Relm, Ear-

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2 Goetz moved to VPI in 1967, Tullock in 1968, and Buchanan in 1969. Goetz and Tullock originally named the center the "Center for Studies in Public Choice." The name was changed to the present "Center for Study of Public Choice" shortly after Buchanan arrived in 1969.

3 The agreement with George Mason University was signed in the Spring of 1982, and the first wave of Center personnel started at GMU in the Fall 1982 term. The remainder of the Center staff completed the move to GMU for the Fall of 1983 term.

4 *Public Choice* emerged from a series of volumes called *Papers in Non-Market Decision Making* that had been published by the Thomas Jefferson Center at UVA and at Rice University for a year. The "new" *Public Choice* journal was introduced as Tullock left Rice for VPI.

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heart, Lilley, and Scaife foundations, along with those provided by the NSF and the university, helped make the intellectual life of Blacksburg far richer than it might have been in a small university town in rural southwestern Virginia.

In Fairfax, the public choice center was largely reconstituted rather than created. Buchanan, Tullock, Crain, Lee, Brennan, and Reid moved lock, stock and barrel from VPI (now called Virginia Tech) to George's Hall, a former Methodist church donated to GMU by the Carow family.<sup>5</sup> The prolific Robert Tollison took over as general director of the Center in 1984.<sup>6</sup> Under his tutelage, the center remained a dynamic place: new faculty were hired, and others replaced as they left for greener or browner pastures. The Buchanan House project was completed. The journal *Constitutional Political Economy* was launched by Richard Wagner and Viktor Vanberg. Visitors continued to be welcomed from around the world.

At George Mason University, the research program of the Virginia school began to have a direct impact on national policies – as many ideas developed and analyzed by Public Choice scholars, and indeed some of the scholars themselves, played a role in the Reagan administration – most notably through Jim Miller's influence as Chairman of the FTC and Director of the Office of Management and Budget. Buchanan and others affiliated with the Virginia school have been invited to testify before congress on tax and other matters. Further impact was evident in the new constitutions of eastern Europe and Africa as a wave of nation building and constitutional reform swept the worlds non-democratic polities away. Not only was Virginia political economy having an intellectual impact round the world, but also a significant impact on the real world.

Again, it should be emphasized that Virginia political economy was not a research program pursued only in Virginia. A quick look at the journal *Public Choice* would reveal hundreds of researchers from around the world contributing to the ambitious research program of Virginia political economy. Nor can it be said that public choice, per se, is synonymous with Virginia political economy. Other centers of research in Public Choice and Rational Politics flourished during the seventies, eighties and nineties. Other generally complementary approaches to politics and social choice were developed at Mary-

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5 Levy and Rowley joined the "new" center in Fairfax. Tideman chose to remain in Blacksburg, and Brennan planned to return to Australia.

6 Tollison had previously joined the Public Choice faculty at VPI in 1977 and resigned his position there in 1980.

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land, Washington University, Zurich, Carnegie Mellon, Rochester, the University of Indiana, Cal Tech, UC-Irvine and Chicago. New Public Choice societies were created in Europe and Japan. The public choice mainstream was well fed by a constant and varied stream of innovative research. There remained a distinct Virginia school, but it was not entirely, or perhaps even mostly, measured in terms of scholarly output.

Whether or not there would have been a Virginia School of political economy without James Buchanan can be debated, but that his work and leadership at UVA, VPI and GMU played an important role in its development and direction cannot. The intellectual and social center of the Virginia school has always been at or near the place where he and his various mechanical typewriters go to work. His leadership, his depth, his prodigious research output, and his unique emphasis on constitutional aspects of political and other decision making lead to his Nobel Prize in Economics in 1986.

### **II. The Intellectual Enterprise: Constitutional Political Economy and Public Choice**

To appreciate the intellectual enterprise of Virginia political economy, one should begin by reviewing the table of contents of a typical microeconomics or public economics text book. Policy analysis in such a text will be conducted in two somewhat contradictory manners. On the one hand there will be a section that analyzes public goods and externalities problems that demonstrates how government might usefully intervene in such areas to alter private incentives by establishing property rights or modifying incentives through appropriate taxes and subsidies. On the other hand, there will be a section that discusses how price controls, taxes, quotas, tariffs and other government regulations may lead to suboptimal results. Some gains to trade are unrealized because of government inaction, and others because the wrong actions are taken. The fact that the same government is somehow responsible for the latter but may be hoped to correct the former is not very much analyzed or explained. Yet both conclusions suggest that government policies can be improved. Bad policies may be eliminated and better policies put in place, apparently one at a time. In this sense, the policy discussions in most economic texts seem aimed at motivating civic action by students to improve

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public policy – and indeed many economists devote their lives to pursuing such policy improvements.

Although there is no text book treatment of Virginia Political Economy, it is fair to say that the public policy perspective of Virginia political economy differs in several ways from that of the mainstream.<sup>7</sup> First, rather than assume that government policy is more or less exogenous while at the same time discussing policy alternatives, the Virginia school, along with the rest of the public choice literature, assumes that public policies reflect political equilibria of one kind or another. That is to say, both good and bad economic policies on tariffs, industrial regulation, taxes, expenditure and transfer programs are considered to be outcomes of rational individuals operating within a particular political institutional arrangement. From this perspective, undesirable public policies are not generally accidents or mistakes waiting to be corrected, but consequences of self interested rational choices in a particular institutional setting.

Second, the Virginia school argues that to *systematically* improve the equilibrium outcomes of "the political" game, it is necessary to change the rules of the game, not simply to provide the players with better guidance from economists. The Virginia school does not claim that policy mistakes are never made, nor that ignorance on the part of policy makers and voters is unimportant, but rather that these and other aspects of the pattern of observed policy decisions are themselves results of incentives associated with the institutional setting under which policy choices are made. If the policies that we observe reflect the decisions of rational self interested persons operating within a particular collection of rules and institutions, improving public policy decisions will require at least marginal changes in the institutions or constitutions under which policy choices are made. The emphasis on institutional reform found in Virginia political economy goes well beyond that of other analytical approaches to public policy.

Third, institutional alternatives have to be appraised relative to each other, and relative to what is feasible. Just as there can be no presumption that every governmental policy is a good one under existing institutions, there can be no presumption that "the right" institutions may yield such an ideal political process, only potential improvement. Nor can there be a presumption that

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7 Buchanan's public finance textbook provides one vantage point. McKenzie and Tullock wrote an elementary economic textbook, as did Tollison and Ekelund, which can be used to gain somewhat integrated Virginia perspectives on economics.

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every constitutional reform generates an improvement. When a Virginia political economist hears someone claim that "X is a bad" or "the institution Z is a disaster," their instinctive and instructive reply is "compared to what?"

Fourth, although members of the Virginia school are very interested in public policy, generally agree that government decision making can be improved, and would like to see governance improved, the Virginia methodology provides no clarion call to action. After all, constitutions and other institutions can be distinguished from ordinary legislation mainly because they are especially durable procedures and constraints. Consequently, the "rules of the game" can not be revised every day, essentially by definition. In this, the Virginia perspective also differs from the public economics mainstream in that it more naturally leads to a detached scientific analysis of policy formation than to a plethora of proposals for social engineering.

The breadth of the main currents of the Virginia research program can be further appraised by considering the contributions of three of its most prolific researchers. These three prolific scholars account for about a thousand published articles and fifty books. Buchanan's many articles and books on constitutional political economy examine a variety philosophical and scientific problems beyond the scope of mainstream economics: the nature of man, the justification of collective coercion, the appropriate methodology for evaluating policy alternatives, the advantages of various external and internal constraints such as the balanced budget amendment, generality rule or work ethic; the role of culture in economic development and political stability. Tullock's books on legal systems, the bureaucracy, rent-seeking, and federalism direct attention to deficiencies in current American arrangements while suggesting alternatives. Tollison's many books and articles on the political economy of regulation, on legislative processes, on the catholic church, on popular culture, on the impact of governmental institutions and on interest groups similarly range far beyond the normal index of typical industrial organization or microeconomics textbooks.

Again, it would be wrong to suggest that the bulk of Virginia political economy can be accounted for by these three well springs of research. Such a perspective would be a gross oversimplification. It is clear that the many co-authors of the various Buchanan and Tollison projects have contributed much to their output and to that of the Virginia school. Formal seminar life in lecture rooms and informal seminars in the hallways of the various public choice centers have also always been an important part of the ebb and flow of ideas at the "center." The academic meetings of the Southern Economic Associa-

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tion and the Public Choice Society have always been great trading posts and melting pots of Virginia school ideas and analyses in various meeting rooms and restaurants.

Moreover, as noted above, research in the Virginia tradition extends well beyond Virginia. Such eminent scholars as Dennis Mueller and the late Mancur Olson have considered themselves "Virginians." Many prominent European political economists such as Bruno Frey, Fridrieich Schneider, Peter Bernholz, Viktor Vanberg, to name a few, also clearly work in the Virginia tradition, as do many scholars in Australia, Canada, Japan, Korea and elsewhere. The many and varied graduates of the public choice Ph. D. programs have made substantial contributions to the Virginia School's scientific research. The two year backlog of articles forthcoming in *Public Choice* is partly attributable to the torrent of Virginia School research that continues to pour forth from around the world.

Yet, it is not entirely because of laziness or a tendency to over simplify that academic "focal points" or "super stars" attract so much attention. Much of the work that takes place in the Virginia tradition has clear roots in the early and continuing contributions of, perhaps, a dozen path breaking scholars.

Among these, it is fair to say that the work of James Buchanan stands out as being very early (1949), very deep, very rich, very large and consequently very influential. Buchanan has made numerous contributions to every major debate and to most minor debates within the Virginia school. In many cases, Buchanan is responsible for launching entire research programs as for example in the areas of leviathan models and constitutional political economy. In others, his work has pushed existing research programs off in new directions. There is a surprising originality and coherence to his work that keeps his research fresh, and yet congenial to his many long time supporters and readers. As one of his colleagues once told me, "Buchanan writes faster than most people can read." It is clear that had a Virginia approach to political economy emerged without Buchanan's influence, it would have been a smaller and much narrower research program.

### **III. The Network of Students, Colleagues and Fellow Travelers**

A school of thought can, in principle, exist in a disembodied form. Independent scholars from around the world, may simply interact impersonally via scientific publications in academic journals. Indeed, this detached and decentralized mode of science has been essential to scientific development in the modern era insofar as it allows the intellectual energies of scholars round the world to be concentrated on research rather than social network building. Yet the personal touch, collegiality, and direct communication can also enhance scientific production. It is largely for this reason that the great centers of research continue to exist. In a few scientific areas there are economies of scale associated with fixed costs (laboratories and libraries), but nearly all areas of research seem to benefit from the advantages associated with direct personal and professional contacts among scholars.

The Virginia school's network of colleagues, students and fellow travelers must rank among its outstanding accomplishments and assets. To put the network in perspective, it should be kept in mind that the public choice center has never been at a "super school." Rather, it has made itself a peak of excellence at whatever school that it found itself. Thus, the "Virginian" network is not based on the historic connections and traditions that one finds at the great established university centers where many generations of scholars and students have crossed paths and developed long and strong networks. The Virginia network is relatively new and to a significant degree centered on the Center for Study of Public Choice rather than the universities with which it has been affiliated. Moreover, the network, perhaps even more than the Virginia research program, has been developed by and centered about the person of James Buchanan.

I do not claim to fully understand the dynamics that generated the network, nor how it operates in all respects, but it appears to be based on a combination of three inter-related elements: (i) the research program, (ii) loyalty and hospitality of the center, and (iii) the ideology of many members of the Virginia school.

To begin with, the more inclusive public choice research program as it developed in the 1950s and 60s was undertaken by a relatively small group of very energetic, creative, and inspirational scholars in an area where the pre-



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vailing orthodoxy in economics and in political science regarded the work to be inappropriate. Even more so than today, economists were oriented toward studying markets, narrowly defined, and toward developing policy prescriptions to resolve market failures in the small and in the large. Government was not only exogenous, but it was a matter studied by other disciplines and thus beyond the scope of economics. Even today, work published by economists in leading political science journals is often not counted for tenure and promotion. On the other side, political scientists regarded the deductive methodology of micro-economic approach with suspicion, or at least skepticism, as something economists did – not political scientists, who were more data (especially survey) oriented in their work on elections, and more "big picture" oriented in their views about domestic and international politics. The relevant focus was on leaders and organizations not ordinary individuals. The preferred political science approach to public policy was almost ardently non-mathematical, historical rather than analytical and statistical.

As a consequence the various participants in the public choice and rational politics research agendas felt like intellectual pioneers, but were often treated as odd outcasts at their home universities and departments. They naturally sought and received each other's support intellectually, and to some extent socially, at academic meetings. At a Public Choice Society meeting, a whole idea can be explained in a sentence, and responded to immediately. Those working away from the handful of public choice oriented centers would have to first teach their colleagues what rational politics was about, or persuade them of the usefulness of the deductive analytical methodology before obtaining even limited feedback at home. Consequently, the public choice meetings in the US and in Europe often have the atmosphere of an intellectual homecoming, a gathering of scholars who feel a bit isolated at their home universities, but who feel at home among friends and colleagues at the meetings.

The general intellectual resistance of the mainstream to the rational politics research agenda has probably caused all its many practitioners to have stronger personal bonds than tends to be the case in mainstream areas of work. In this manner the worldwide public choice network came to include a very significant fraction of the researchers who used rational choice models to analyze political decision making. Within the public choice community, obviously those with greater shared interests came to be closer colleagues and friends. Those whose research interests more closely aligned with the Virginia tradition in methodology, in focus, and in ideological subtext, gen-

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erally tended to be closer colleagues than those whose interests are less congenial.

The Virginia network within the public choice community is stronger than these purely social and scientific influences would suggest because for much of its history, the Virginia presence within the American Public Choice Society has been very substantial and relatively powerful. Consequently, the connection of between Virginia school and the international public choice network has always been quite extensive.

Beyond the largely scientific based network of the public choice society, per se, there are several other branches of the Virginia network that extend worldwide. Two of these are noteworthy. There is a fairly large collection of non-profit organizations that have been interested in promoting conservative and libertarian ideas, in which a subset of public choice ideas have long been influential. After all, one rationale for constraining government is the concept of "government failure," e.g. the proclivities of governments to make "mistakes" or enact policies that are systematically biased away from the public interest in at least some policy areas. Such policy conclusions often follow from the research of those working in the Virginia tradition and resonate with the intuitions of many conservatives and libertarians.

It is largely from this confluence of interest that the Center has received much of its private funding, and much of its reputation beyond academic public choice and public economics circles. It is partly from this part of its network that the Virginia school and public choice came to be regarded as conservative enterprises in spite of the fact that the methodology, itself, is value neutral, and that the Virginia school includes several prominent American liberals among its loose membership. The conservative connection has also contributed indirectly to the center's prominence insofar as such more or less conservative views tend to be underrepresented in American academia.

In addition to the professional and ideological branches of the network, there is also a nexus of students and visitors from around the world who have learned the Virginia outlook at the center or elsewhere, and who return to the center from year to year and send their colleagues back home along to the center. A surprising number of international scholars have met each other, or heard of each other's work, for the first time while visiting the Public Choice center. Both visitors and graduates have used the network to identify colleagues with shared interests, and to expand their range of contacts among fellow travelers. And, as is perhaps typical of most successful academic networks, many friendships have been initiated by those whose main initial

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commonality was simply visiting a particular intellectual center, the Center for Study of Public Choice, at a previous point in their lives.

Here, the hospitality of Betty Tillman, Buchanan's secretary, bears special notice. Betty has always played a large role in organizing and promoting Jim's research and travels, but she has also played an important role in maintaining the expansive Virginia school network.<sup>8</sup> Her warm greetings and southern hospitality are literally world famous, and help to make visitors and former students feel welcome to a place where truthfully it may be said that "the work comes first." Many visitors stay in her guest rooms when they come to town. Moreover, she has always made students and visitors feel as if they are members of a family, complete with vaguely defined familial duties, loyalties, and obligations. In the last decade or so, Carol Robert also done yeoman work in making center visitors from around the world feel comfortable in George's (now Carow) Hall.

Again the mainstream's resistance to the public choice agenda tends to reinforce the bonds among students and visitors, making them stronger than would normally have been the case among a group of independent minded scholars from the four corners of the world. Many are the visitors who report feeling intellectually more at home at the Center for Study of Public Choice, than back at their own universities often many thousands of miles away from Virginia. The "outcast/vanguard effect" is doubtless diminishing as the public choice research agenda has begun to be accepted and extended by the mainstream intellectual centers, but still has some importance insofar as the Virginia School retains its own unique research agenda and cast of characters.

Buchanan's role in building and maintaining the Virginia network is both striking, and somewhat surprising. It is fair to say that Buchanan is not a "people person" because he has always been somewhat reticent and uncomfortable with strangers. On the other hand, he has the ability to inspire great loyalty from his friends and fellow travelers. I suspect that the latter arises partly from his tendency in conversations to hear the very best said. Rather than noting the errors and confusions that would attract attention from many academic scholars, he nearly always focuses on the insights and strengths of his visitors. This leads to a very pleasing, but apparently accidental, tendency to flatter his visitors somewhat by finding greater coherence and insight in

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8 Betty was associated early on with the Virginia school in Charlottesville where she worked in the economics department as Buchanan's secretary. Betty moved to Blacksburg from UVA at about the same time that Tullock and Buchanan moved there, and from there to Fairfax to continue with Buchanan and the center.

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their words than may be appreciated by those who spoke them. This unassuming conversational method naturally impresses students and visitors and makes them feel appreciated by a very bright man – for perhaps more than they are.<sup>9</sup> I once received a fortune cookie that seems to characterize this process of conversational intercourse very well: "a wise man learns more from a fool than a fool from a wise man." A wise man hears more than is said.

Buchanan's intellect and novel world view have brought with them a world wide reputation and invitations to meetings and speaking engagements round the world. And his travels, in addition to his personality and voluminous work, have contributed substantially to the Virginia network by increasing the number of fellow travelers, inspiring them to further work, and welcoming them – regardless of their nationality, intellectual roots or talents – to the Virginia school.

### **IV. Buchanan and the Future Virginia School**

A river by cutting through a hillside or mountain range may cause other streams and rivers to flow to sea by different channels. In this manner, a river may enlarge itself by redirecting others. Surely, the same sort of effect can be attributed to both the Virginia school and the work of James Buchanan within that school. By raising new issues and recasting old ones, the Virginia school has attracted and flourished by attracting the interest of scholars world wide.

It may be argued that without the powerful flow of its most prolific contributors, the Virginia school would not have come to much attention, nor managed to attract new contributors. The old barriers would have shaped the course of the research rather than been reshaped by it. Thus, by analogy, one can see the importance of powerful wellsprings in establishing the course of a

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9 On the other hand, it probably bears noting that Buchanan, Tullock, Tollison and some other members of the Virginia school are not always as generous with their critics as they tend to be with fellow travelers. This leads many outside the Virginia school to feel less comfortable with Virginia political economy than they might otherwise have been on purely methodological grounds. It may be argued that this, too, contributes to the network by increasing the "outcast" pressures mentioned above that many isolated researchers feel, and increasing the relative appeal of the Virginia school, but the net effect is not obvious.

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new philosophical and scientific approach to political economy, while at the same time seeing an answer to the question of whether the Virginia research program can survive without its most prolific tributaries.

Those skeptical about the future of Virginia political economy might agree that many original contributions in many different directions have been generated by dozens of other researchers working in the Virginia tradition, but wonder how many of those were in response to work by Buchanan, Tullock, Tollison, or Olson? There is a powerful and cutting edge that emerges from a prolific mind that is not easily replicated by a dozen less energetic or less penetrating ones. What if a major wellspring disappears or is walled off?

The river analogy suggests an answer: once a new channel is created, a good deal of water may still follow a new course to the ocean even if a powerful wellspring is subtracted or diminished. Here one may note that the Virginia research program has so many interesting questions left and so many creative and talented people around the world working on them that the future course of Virginia political economy remains very promising. In this sense, a powerful and penetrating flow of research may be more important for launching a new course of research than in its continuation once started. The work of a single scholar or small group of scholars may be more critical for establishing a school of thought than for its continuation.

Yet – it must be acknowledged that the question is a serious one. Even if we accept this conclusion about prospects for the future of Virginia political economy, it is clear that the fact that such a question must be seriously entertained is further evidence of the significance of a handful of scholars within the Virginia enterprise. Among those major wellsprings of research mentioned, it is clear that Buchanan must stand out for his depth and breadth as well as his volume. Fortunately, as Jim reaches his eightieth birthday, his intellectual energy and power seem as great as ever. Consequently, the channel of Virginia political economy will doubtless be carved still deeper and wider by the torrent of his continuing contributions well into the next millennium.

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### 3 A Young Man of Eighty<sup>1</sup>

HARTMUT KLIEMT

Ladies and Gentlemen, Dear Fellow Members of the Mont Pelerin Society:

Those of us who attended the meetings in Cannes in 1994 will remember Ronald Coase's fine speech in honor of Friedrich August von Hayek. They will recall, too, how Ronald Coase mused why it was he who was giving the speech honoring the founder of this society. After all, he "did not call him Fritz".

Not surprisingly Coase solved the puzzle in terms of transactions costs. As he nicely put it he is "still there rather than in the great library above".

For this society Jim Buchanan clearly plays a role as central as that of von Hayek in former times. So it is obvious why we should honor him on occasion of his 80th birthday. Happily transactions costs are very low in this case. For Jim Buchanan is definitely not only *there* he is *here* and, for that matter vibrantly alive.

The great librarian above will have to wait a long time whilst Jim Buchanan continues filling the libraries down here. Yet let us try to keep him from working at least for this lunch.

Well, at least he is not banging away on one of his ancient type writers right now. This is comforting. For I often get the feeling, as I am sure so many here do that I cannot read as swiftly as he can write.

I'm afraid I will have to take Buchanan's Collected Works with me to the great library above and study on.

Nineteen volumes of manuscript of the Collected Works of James M. Buchanan were delivered to Liberty Fund's publishing branch almost exactly one year ago. In the meantime, the first volume, which gives an overview of the main strands of Buchanan's thinking, has appeared in print. Four other volumes are already on their way to distribution.

Liberty Fund not only proposed the project. In fact, I think, the original idea came from Liberty Fund's vice president, Emilio Pacheco, who is with us here today. It has once again done a marvelous job in processing the mate-

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1 Potsdam, October 27, 1999, The Mont Pelerin Society Regional Meetings



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rial. But Liberty Fund as well as the editors of the series would be the first to acknowledge that the achievement is entirely Buchanan's.

Jim Buchanan, who has always striven for self-sufficiency as a farmer, has proven his self-sufficiency by producing his own 80-th birthday present. His Collected Works are certainly one of the great intellectual crops of our times and we will have to take our time to digest them in full.

As co-editor of the Collected Works I strongly suggest that you start right here rather than waiting for the great library above. I should warn you, though. We had originally planned to edit a final 20th volume to the Collected Works series complete with an index and biographical data. But, given the speed with which Jim Buchanan writes and his amazing productivity in general, this turned out to be grossly naive. Our intellectual farmer from the South has already sown new intellectual crops. And I know that if he gets bored with my speech, he'll turn his attention to some interesting new ideas he's got in the back of his mind even while sitting here with us.

As many of us know from personal encounters, Jim Buchanan's mind works differently from other minds. It functions in accordance with its own rules and agenda. This may sometimes convey the impression that he is somewhat absent-minded or that he doesn't always pay attention in conversation. Now, this may, of course, sometimes indeed be the case, but, in dealing with Jim Buchanan, you must always be on your toes.

Let me give you one example of what I mean. I'm sure we could fill the whole afternoon with recollections like this. But let this one stand for the rest.

On a trip back from Blacksburg to Fairfax this summer, I had just taken over the wheel after Jim had driven for some time. To prove that I can not only pass the all American intelligence test to walk and chew gum but also talk and drive at the same time, I started to comment on a recent Buchanan piece that I had just read a day or two before. There were some very interesting points in the paper to which I offered some minor criticism and some additional observations.

We pursued some of the matters a bit in discussion but after a while, even though I went on commenting, I had the impression that Jim had lost interest. He seemed to be thinking of something else and seemed to not really be paying attention. The conversation dwindled down and I did not insist on continuing. I had a suspicion that Jim had not really heard what I had said. But, as most of you will certainly agree, this is presumably not a great loss anyway and definitely not for Jim Buchanan. So why bother?

## A YOUNG MAN OF EIGHTY

The next day at the office, due to some casual remark, topics related to the conversation in the car came up again. I was then astonished to hear Jim proceed to reproduce details of the conversation we had had, details that I myself could not have recalled on my own. Essentially, he knew better what I had said than I did myself.

This specific, personal incident may provide some clues as to what seems to be behind Jim Buchanan's tremendous intellectual success. As I said, he sets his own agenda. He has his own evaluation function for what is important and what is not. He is interested in the big picture, in the larger lines of argument rather than in solving specific riddles.

As he has described it several times, for him it is like driving in foggy weather. But in his case the driver has "his own drive" so to say. This has, I think, all sorts of consequences for the characteristically 'Buchanan' intellectual enterprise. It also leads to what Anthony de Jasay has described as Buchanan's proclivity to take "criticism in a grand manner".

In fact, this attitude is not confined to specific details of his arguments, but extends beyond to broader and truly fundamental issues. To fundamental objections, Jim Buchanan might respond with the friendly remark: "this is a very good point". I think many of you have heard him say this. And more often than not, Jim Buchanan would be content to let it rest with that. But this should not be misunderstood as an unwillingness to respond to criticism. It must rather be seen in perspective.

First of all, Jim Buchanan is too much of a gentleman to make you feel that your criticisms are old hats. Even if he has heard a certain argument a hundred times, he might give you the impression that it is new to him.

Secondly, if you read fully through Buchanan's writings and also included some of his less well-known stuff, you would be surprised at how many of the criticisms have been dealt with somewhere. In response to some objection, either raised by himself or by someone else, Buchanan might for the sake of the argument give up some premises which he would, nevertheless, use in other contexts.

Thirdly, regardless of the preceding observation, it should also be noted that Buchanan's life-long work has a remarkable degree of coherence. It is not only large and extended it is also integrated by a set of simple principles that have basically been present from its very beginning. This deeper philosophy, these Lakatosian do and do nots of the Buchanan trade, somehow hold the otherwise extremely spread-out intellectual interests together and make the whole much more than a simple sum of its parts.

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The most fundamental of those principles are presumably more of the implicit rather than of the explicit type. However, some of the principles can at least be named and labeled even if a broad characterization does not do them full justice.

In a most abstract and stenographical way, Buchanan's philosophy could be characterized as "Kantian". Since there are almost as many views on Kant as there are Kantians, this does not say too much. What kind of animal you are dealing with depends on the specific set of elements that you pick from Kantianisms many shelves.

The essential Kantian elements in Buchanan's thought can easily be pointed out. On the one hand, the world as we perceive it, as scientists or as common citizens, is to some extent made or constituted within the process of perception. What we deem real is constituted in a rule-governed way. There is a constitution of the individual as well as of the collective intellectual enterprise which affects the process of inquiry as well as its results in a fundamental way.

There is also a distinctly Kantian element in Buchanan's philosophy of science. Jim Buchanan has always rejected petty empiricism in social science. Short sighted applications of statistical methods have been characterized by Buchanan as efforts to prove that water runs down hill. However, a v. Misesian approach to human behavior based on a priori insights is clearly not Buchanan's cup of tea either. Buchanan is a reluctant empiricist who tries to combine a priori and a posteriori insights in a somewhat uneasy manner with certain normative concerns.

Political economy is not a discipline like physics. But it is not like engineering either. Buchanan insists that as a political economist he is not trying to save the world but he clearly intends to make it a better place. Contrary to more elitist intellectuals – including many Keynesians – he is not intending to outsmart others. Manipulation of others is entirely illegitimate. The social engineer who adopts the detached, objective attitude of an external observer and is willing to serve the purposes of whatever master is interested in his technique is not the role model of the Buchanan type political economist. The Buchanan type political economist is himself participating in an ongoing discussion among a community of equals whose genuine agreement he is seeking. In that sense the constitution of political economy is built on aims other than furthering knowledge.

On the ethical side of the philosophical street, we find the Kantian respect for the autonomy of the individual even more explicitly than on the methodo-

## A YOUNG MAN OF EIGHTY

logical side. When Buchanan refers to himself as a contractarian, then it is this, rather than any notions of unanimity or virtual contract, which is the essential element. Other than Kant, Buchanan would certainly not claim to have any a priori knowledge of what is ethically right and wrong. Still, even though acknowledging a certain conventionalist element in the justification of his most fundamental value premises, he would insist that they are non-arbitrary. They are relatively absolute absolutes which come along with the most fundamental elements of western civilization.

Jim Buchanan's practical Kantianism is not reserved for Sunday speeches, but is an integrative part of his way of life. He might get angry sometimes at other people and their ways. Sometimes his spontaneous reactions may even seem slightly unjust, in particular when he is angry. However, on closer inspection one finds that Buchanan's anger is typically stirred by what he perceives as a lack of inter-personal respect. Putting aside all my admiration for his intellectual achievements, what makes me respect Buchanan as a person is this serious and never-ending effort to respect other beings and their personalities – dogs, of course, not excluded.

I know that many other people feel the same way, many of you present today. For when Viktor Vanberg and I once organized a conference at the ZIF in Bielefeld under the title "James Buchanan Meets His German Friends and Critics", we found out that his friends were his critics and vice-versa. Knowing how the world ticks and taking into account what a nasty, suspicious and envious species we are, this is an amazing achievement.

The Mont Pelerin Society is blessed with having Jim Buchanan as one of its leading figures. So, allow us, Jim, to show you the respect you deserve and the friendship we feel for you. We shall reconvene on your 90th, but for the time being, let us rise and give you a warm round of applause. Three Cheers for Jim Buchanan!

## 4 Buchanan-as-Artist: A Retrospective

WILLIAM BREIT

- I. Prologue
- II. Selected Chronology

### I. Prologue

"All art consists in bringing something into existence."  
Aristotle, c. 340 B.C.

It is my pleasure to send greetings to James Buchanan on the occasion of this celebration. He has played so many important roles in my life (gracious friend, inspiring colleague and stimulating mentor) that my debt to him is greater than I could every repay. But I shall at least take this opportunity to engage in a little fun in the knowledge that for over thirty years he and I have been co-conspirators against those who take themselves too seriously. Moreover, he will undoubtedly detect the strong undercurrent of seriousness in what follows. The economist-as-artist is an insight that we share. Jim Buchanan is an artist par excellence. Like other great artists who paint brilliant canvases, he has created a world and persuaded legions of followers that his perception of the world is correct. In accomplishing that feat he has indeed made their world what it is. Therefore to mark this milestone in his life it is fitting that James Buchanan, the preeminent representative of that school of art known as Public Choice-Constitutional Economics, be honored by a retrospective exhibit in the "Imaginary Museum of Modern Economics". The chronology in the catalogue that accompanies the exhibit follows.

## BUCHANAN-AS-ARTIST

### II. Selected Chronology

"Ars longa, vita brevis"  
Hippocrates, c. 400 B.C.

This chronology compiles and consolidates information available in the James Buchanan literature, including most extensively his memoirs, *Better Than Plowing*, published in 1992 by the University of Chicago Press. It has benefited greatly from access to his vita on the internet as well as conversations with him over the many years of our acquaintance. It is highly selective in that it excludes mention of many works, although of interest in themselves, that do not, in the opinion of this curator, represent as significant breakthroughs in Buchanan's thought as do those included in this retrospective.

1919 Born in Murfreesboro, Tennessee, the grandson of John P. Buchanan, erstwhile Populist governor of Tennessee, and the son of Lila Scott and James McGill Buchanan, both of pure Scotch-Irish descent.

Grows up on the family farm in rural agricultural poverty. Since the farm had no clear-cut owner he early learns the importance of clearly defined property rights to provide the incentive for effective maintenance.

His mother and father assumed leadership roles in their local community. From his mother, who was a public school teacher, he receives home instruction that advances him two grades. She continues this help even through his college years.

1940 Graduates first in his class with a B.S. from Middle Tennessee State College where he majors in mathematics, English literature and social science and matriculates at the University of Tennessee at Knoxville.

Meets Professor Charles P. White at Tennessee whose scholarly work habits influence his own and who instills in him the belief that there is a moral element in academic pursuits.

1941 Graduates with an M.A. in economics from the University of Tennessee, Knoxville.

## WILLIAM BREIT

Drafted into military service, undergoes officer training in New York and at Naval War College. Along with others, is subjected to overt discrimination based on favoritism for graduates of eastern establishment universities. This leads him to embrace a socialist position on social policy by virtue of which he becomes sympathetic to the possibility of politicized decision-making as the instrument by which social justice is achieved.

- 1941- Stationed in Pearl Harbor on the operations staff of Admiral Chester  
1945 W. Nimitz, commander-in-chief of the Pacific Fleet and later stationed at Guam.  
Awarded a Bronze Star for distinguished service.  
Meets Ann Bakke who is working at Hickham Field, Oahu, with the Army Air Transport Command.  
Buchanan develops a great respect for the military leaders for whom he works. Notwithstanding the urgings of important people who encourage him to stay in the military, he decides to pursue an academic career at war's end.
- 1945 Marries Ann Bakke in San Francisco and reports for temporary duty in New Orleans.  
Proceeds to Memphis, Tennessee where he is released from Navy.
- 1946 Matriculates at the University of Chicago to work toward a Ph.D. in economics.  
Enrolls in price theory class taught by Professor Frank H. Knight. Knight's teachings inspire the young economist to develop a skeptical attitude towards ideas and a new perspective for interpreting reality. The attitude: in the search for truth nothing and no one is sacred. The perspective: to see markets as coordinators of human interaction and a mechanism of exchange that increases utility. This leads the young Buchanan to reject the economizing-maximizing paradigm of economic orthodoxy as well as his earlier socialist views in which the political process overcomes "market failure." From this time onward his angle of vision sees market exchange as an institution than can best solve economic problems without coercion.

## BUCHANAN-AS-ARTIST

- 1948 By chance, Buchanan discovers Knut Wicksell's 1896 unknown, untranslated doctoral dissertation on taxation in the University of Chicago's Harper Library. Translates it from the German. The message: government should not be viewed as a benevolent despot. Political outcomes are the result of the interaction of persons in varying roles acting in their self-interest. The test of efficiency in the public sector can only be guaranteed by the rule of unanimity. Reforms in economic policy therefore require a change in the rules under which political agents act.  
Receives Ph.D. in economics.
- 1948- Associate Professor to Professor, University of Tennessee, Knoxville-  
1951 ville, Tennessee.
- 1951- Professor, Florida State University, Tallahassee, Florida.  
1956
- 1956 Professor of Economics, University of Virginia, Charlottesville, Virginia.  
Fulbright Scholar in Italy where he reads widely and deeply in the works of the Italian masters of public finance. He discovers the Italian perspective on politics: "the state" is always viewed through the observed activities of its all-too-human agents.  
Gets idea for his first singly authored book in a sudden epiphany while staying at a hotel in Rome. In his words: "The moment of enlightenment came while I was walking down the marbled stairs between floors on the occasion of mechanical failure of the lift. I treasure the memory of that moment because we rarely are able to locate the emergence of ideas so distinctly. I waxed so enthusiastic over the 'discovery' that I commenced writing what later became my book on stationery picked up from the hotel writing room."
- 1958 Publishes *Public Principles of Public Debt* in which he rejects the Keynesian-inspired macroaggregative approach in favor of "methodological individualism" in which individually identified utility gains and losses is the method of analysis.



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This paradigm ultimately is to become the behavioral model underlying all of his future landmark contributions to his new political economy.

Gordon Tullock comes to University of Virginia as a postdoctoral research fellow. Buchanan joins forces with Tullock and together they begin to produce the first systematic exposition of the way of thinking that later came to be called "public choice."

- 1962 Publishes *The Calculus of Consent: Logical Foundations of Constitutional Democracy* co-authored with Gordon Tullock. This is his first exhibit in book form of what is now called "constitutional economics." Makes use of Buchanan's Wicksellian emphasis on the rules within which political choices are made combined with the methodological-individualist model of analysis Buchanan pioneered in his public debt book. Tullock contributes his vision of the behavior of persons in bureaucratic roles. This work is quickly relegated to the status of a "classic." From the publication of this work the relevant issue in political economy becomes the comparison between the workings of the market, however imperfect, and the operation of its imperfect political alternative.
- 1963 Elected President of the Southern Economic Association. His presidential address, "What Should Economists Do?" explicitly argues for the removal of the theory of resource allocation from the center stage of economic study to be replaced by the theory of market exchange in which individually identified gains and losses in utility in the exchange process are analyzed.
- 1968- Serves as Professor of Economics at the University of California,  
1969 Los Angeles, California.
- 1969 Accepts position as University Distinguished Professor at Virginia Polytechnic Institute and State University in Blacksburg, Virginia. Named General Director of the Center for Study of Public Choice. Publishes *Cost and Choice: An Inquiry in Economic Theory*, a work that attempts to clarify the concept of opportunity cost and again reduces economic analysis to individual choice settings and in doing so defines cost in utility rather than commodity dimensions.

## BUCHANAN-AS-ARTIST

- 1971 Receives Outstanding Alumnus award from his undergraduate alma mater, Middle Tennessee State University in Murfreesboro, Tennessee.
- 1975 The University of Chicago Press publishes Buchanan's most coherent single statement of his political economy: *The Limits of Liberty: Between Anarchy and Leviathan*. This work was stimulated by Buchanan's growing disillusionment with the democratic process. His sanguine view of that process derived from his belief that governing authorities, under constitutional restraint, will be responsive to the preferences of the citizens. However, explosive government spending on new programs unrelated to the will of the citizenry suggests to him an unleashed Leviathan, and the turbulent, violent years of the late 1960's after the eruption of the Vietnam war pointed toward the emergence of anarchy in civil society. This new work presents the theories that enable him to predict the operating properties of both anarchy and Leviathan.
- 1976 Elected as a Fellow of American Academy of Arts and Sciences.
- 1980 Publishes (with Geoffrey Brennan), *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. This work presents the formal analysis of the threat of the Leviathan state that was first raised in *Limits of Liberty*.
- 1982 Receives Honorary Doctorate, (Dr.h.c.) University of Giessen, Germany
- 1983 Joins the faculty of George Mason University in Fairfax, Virginia, as General Director of the Center for Study of Public Choice.
- 1984 Recipient of the Frank E. Seidman Distinguished Award in Political Economy.  
Receives Honorary Doctorate (Dr. h.c.), University of Zurich.
- 1985 Teams again with Geoffrey Brennan to produce *The Reason of Rules - Constitutional Political Economy*, a sequel to their earlier work on taxation.

## WILLIAM BREIT

- 1986    Receives Nobel Prize in Economics.
- 1988    Honoree, "James Buchanan Day," Rutherford County, Tennessee, City of Murfreesboro, Tennessee.
- 1988-    Recipient of numerous honorary doctorates.
- 1999    Authors and/or edits over a dozen volumes of his work.
- 1999    Retrospective at the "Imaginary Museum of Modern Economics", (in cyberspace), curated by William Breit, on the occasion of James Buchanan's 80th birthday.

## **Part II**

# **Methodological Aspects of Buchanan's Work**

## 5 Science and the Social Order<sup>1</sup>

HANS ALBERT

- I. Overcoming the Classical Idea of Rationality
- II. The Role of Values in Social Science
- III. Social Technology and Social Practice
- IV. Norms, Law and Morality: The Role of Normative Regulations in Social Life
- V. Law and the Idea of a Rational Jurisprudence
- VI. The Problem of an Adequate Social Order

The problem of an adequate social order is one of the main concerns of James Buchanan and his theory of constitutional political economy.<sup>2</sup> Ultimately, this problem seems to be one of a normative nature. And the problem of the conditions of adequacy of such an order seems to be a central question of social philosophy. What I want to show in this paper is how it is possible to come to a rational solution of the problem and how social science can make an important contribution to this solution.

### I. Overcoming the Classical Idea of Rationality

The classical idea of rationality which has been dominant in philosophy, in science and in other realms for more than 2000 years has been connected with the idea of sufficient justification. Sufficient justification is to be understood as a procedure which leads to a guarantee of truth for the respective

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1 This is a paper I presented at the Center of the Study of Public Choice on 24th September 1990 in Fairfax, VA, upon invitation by James Buchanan. I am grateful for many interesting discussions on that and on other occasions. And I am very grateful also to Allison Blizzard for correcting my broken English.

2 Cf. JAMES M. BUCHANAN: *The Limits of Liberty. Between Anarchy and Leviathan*, Chicago/London 1975.

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propositions or views, or more generally, for the solutions to the problems involved. This idea can be found in Aristotle, Descartes, Husserl, Dingler and even, after the Second World War, in Lorenzen, Apel and Habermas.

In opposition to the view of classical rationalism, the representatives of scepticism have always made valid objections<sup>3</sup>, but without success. They have not been able to undermine the classical view, perhaps because they have never presented a convincing alternative. That may be a consequence of the fact that they themselves implicitly accept the classical idea of knowledge, a utopian idea, as it were.

In science this idea has been discredited by the success of both Einstein's theory of relativity and his epistemological views. And in mathematics the antinomies of set theory brought Bertrand Russell to the conclusion that we have to abandon the belief in mathematics as the "last province of certainty". Afterwards, Imre Lakatos introduced fallibilism into mathematics in his famous "Proofs and Refutations".<sup>4</sup> And Karl Popper came to the conclusion that the classical idea of knowledge has to be corrected and that the principle of justification has to be replaced by his principle of critical examination in methodology.

Now, because cognitive, even theoretical, assumptions are involved in every solution of practical problems, the revision of the classical view is, of course, valid for all problem areas: from science to politics, morals and even religion or art; in every area where problems arise and have to be solved. But abandoning the classical view does not mean giving up the classical idea of truth or of adequate representation of states of affairs, for consistent fallibilism presupposes this idea. In addition, the critical realism of classical epistemology is, in my opinion, indispensable as a background needed for an adequate methodology of factual science. This methodology is a kind of technology of cognitive practice, aiming at the growth of scientific knowledge. The practice of science is a specific mode of problem-solving behavior, applying methods and criteria which are directed at this aim and which depend on the possibilities of action with respect to this aim.

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3 Cf. RICHARD H. POPKIN: *The History of Scepticism from Erasmus to Spinoza*, Berkeley/Los Angeles/London 1979, cf. also ALAN MUSGRAVE: *Common Sense, Science and Scepticism. A Historical Introduction to the Theory of Knowledge*, Cambridge 1993.

4 Cf. IMRE LAKATOS: *Proofs and Refutations. The Logic of Mathematical Discovery*, Cambridge 1976.

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There are some structural properties, which are characteristic of all problem-solving behavior:

(1) This behavior is, of course, dependent upon the context. In every problem-situation, there is a large number of presuppositions which give structure to the situation. Though any of them may be removed, it is never possible to remove them all at the same time. They constitute the frame of reference for the problem at hand.

(2) It is always possible to dogmatize solutions or components of solutions. Dogmatism is not only possible in cognitive or in religious practice but generally in any social practice. There are many procedures for immunization against criticism, but all of them are obstacles to solving problems.

(3) Any problem-solving activity depends on decisions under conditions of scarcity and uncertainty. Scarcity and uncertainty are general features of the human condition.<sup>5</sup> All models operating with certainty or even with calculable risks are, at best, usable as approximate solutions for practical situations.<sup>6</sup>

If we accept fallibilism, which is connected with these properties of the human condition, there can be only some general guidelines for problem-solving behavior: analyse the problem situation at hand and identify the existing problems and proposals for their solution, compare these solutions with respect to their merits and weaknesses in the light of certain performance characteristics or criteria, search for other solutions which are better with respect to these criteria, and select the best of these alternatives.

The criteria involved will depend on the respective problem areas: science, art, politics, economy, law, religion, and so on and on the aims to be achieved. But aims and criteria are also subject to criticism and revision.

To contrast the classical and the new idea briefly: The former means to identify the true solution and to show that it is true, the latter to find and compare possible alternatives and to choose the best.

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5 Cf. my book: *Traktat über rationale Praxis*, Tübingen 1978, p.25f.

6 Cf. HERBERT SIMON: *Reason in Humans Affairs*, Oxford 1983.

## II. The Role of Values in Social Science

It seems trivial that any social practice - and therefore the cognitive practice of science - involves valuations and decisions depending on these valuations. This has never been denied by the defenders of the principle of value freedom. They have even explicitly emphasized this fact and tried to distinguish the different aspects of the problem of value. That is especially true of Max Weber whose views have been incredibly distorted by many social scientists.<sup>7</sup> In the discussion about the social sciences, people usually attack an idea of value freedom which is defended by no one, at least by no participant in this discussion.

In spite of the fact that all practices involve valuations and decisions, a value-free science and especially a value-free social science in accordance with Weber's views is possible, that is, a science which does not contain value-judgments within the system of propositions which refer to its objects, within its theories, explanations and descriptions. Such a science is practical and, in my opinion, even useful for analysing the problem of an adequate social order. I shall come back to this problem later.

In everyday life and in some philosophical views which accept the illusions of common sense, it is a customary assumption that there is a special cognition of values and that value-judgments, therefore, are to be interpreted as cognitive statements, as having a truth-value: true or false. This value-platonism has been convincingly criticized. For the interpretation and explanation of human behavior and the valuations and decisions connected with it, it is not necessary to ontologize the standards which are applied by human beings. Therefore, it is not necessary to assume that "values" belong to the structure of reality.

Usually, the value-standards which are used to adopt a positive or negative attitude to certain aspects of reality refer to natural properties which, at least partly, are relevant to the solutions of practical problems. In value-concepts, therefore, a descriptive component is connected with a positive or negative value-accent. Therefore, a rational discussion of value-judgments

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7 Cf. for example HERBERT MARCUSE: "Industrialisierung und Kapitalismus", in: OTTO STAMMER (Ed.): *Max Weber und die Soziologie heute*, Tübingen 1965, S. 161-180, and my criticism in: *Wissenschaft und Verantwortung. Max Webers Idee rationaler Praxis und die totale Vernunft der politischen Theologie*, Mens en Maatschappij 1970, p. 298-318.



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can usually refer to their descriptive components, as Weber has shown. And he has explicitly stated that criticism does not stop at this kind of judgment. Finally, such a discussion has to go back to the aims and requirements accepted by the people involved.

Also, the ideals or regulative ideas which are dominant in the different realms of human culture - ideals of truth, justice, beauty, and so on. - can be discussed rationally in this way. The fact that they are human inventions or cultural achievements does not put them beyond discussion. And the fact that value-judgments do not express a special kind of knowledge but only requirements adopted by people with respect to the adequacy of problem solutions does not make them less reputable statements.

Similar things can be said about rules and about the class of rules which are usually described as norms. Just as there is no "realm of values" which has to be characterized as part of reality, there is no "cosmos of norms" which can be grasped by human cognition. Like values and ideals, norms are cultural achievements which play a very important role in social life, even though they are not to be characterized as quasi factual givens, as parts of reality. Their factual validity depends on their efficacy in social life. I have to add only that an ontology which has no use for a "realm of values" and a "cosmos of norms" can, nevertheless, be connected with constant and strong moral and political convictions, which many historical instances prove.

### III. Social Technology and Social Practice

For the practical use of scientific knowledge, it may be necessary to form technological propositions or systems of propositions connected with possible aims of actions. An attempt to solve the problem of an adequate social order in a naturalistic framework by means of social-technological propositions was already undertaken by Thomas Hobbes.<sup>8</sup> The transformation of propositions of social science into propositions of this kind is a purely deductive operation. We need no additional premisses to accomplish it, especially no value-premisses, for the information content of a technological system

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8 Cf. JOHN WATKINS: *Hobbes's System of Ideas. A Study in the political significance of philosophical theories*, sec. ed., London 1973. Later Max Weber and Karl Popper developed a conception of social-technology.

## HANS ALBERT

does not surpass the content of its theoretical basis and a system of this kind has no normative content.

But, as always, if problems are to be solved by logical deduction, it is necessary to have a standpoint to decide which consequences are relevant for the solution of the problem at hand, for one has to make a selection from an infinite class of consequences. This standpoint must result from the practical problem involved, for instance: "How is it possible for a government in a particular situation to maintain stable prices for consumer goods without introducing price controls, and at the same time avoiding other unwanted effects?" or: "Which kind of legislation is required to bring about some kind of social security in a framework of a social order which includes the guarantee of certain kinds of liberty for the individuals?". As can easily be seen, the practical standpoints have been translated here into restrictions on the deduction of consequences.

Therefore, it is important not to mistake a technological system for a normative one, for the relevance of a technological system for the solution of a practical problem is not to be confused with a legitimation to apply the system in practice. A system of this kind does not answer the question: "What should we do?" but only the question "What can we do if we want to solve a practical problem of a certain kind?". It contains no prescription, but only information about possibilities of action. If we use such a system practically, we have to make decisions about ends and means which are not deducible from technology. Even the decisions about means do not follow logically from the technological propositions. To make this possible, we would have to add a premiss which implies that the end sanctifies the means.

Thus, it is easy to see that purely informative systems of propositions without normative content can be used successfully in practice. Decisive for their applicability is only their relevance for the practical problem at hand. It is trivial that for their use in concrete situations, valuations and decisions are required. As far as I can see, no one has denied this, certainly no defender of Weber's principle. We certainly need norms, but we do not need any sort of normative science, not even for practical purposes.

#### **IV. Norms, Law and Morality: The Role of Normative Regulations in Social Life**

Even if we do not ascribe any cognitive content to normative sentences, we have to admit that social life is, in fact, influenced by normative regulations of different kinds which are partly expressed by normative sentences. In the social sciences, norms are usually analysed as social facts, as cultural achievements, which are "valid" insofar as they are effective in social processes.<sup>9</sup> Therefore, the social sciences are interested in the role played by norms in causal relationships because individuals are influenced by them in their behavior; they follow them, try to bypass them, they trust that other people follow or bypass them, and so on.

It is obvious that from a social science perspective, normative regulations are analysed as historically variable facts, which have a causal significance for the steering of social processes. In attempting to explain social processes, the social sciences must analyse norms in their causal role for human actions. They have to explain the factual validity of norms, that is the fact that they are effective in social systems, and they must explain other social facts by going back to norms and their factual validity.

Since the factual validity of norms is equivalent to the existence of corresponding institutional arrangements, this means that we can make use of the assumptions of the research programme which goes back to the Scottish Moral Philosophers of the 18th century. This programme has two main components: methodological individualism and theoretical institutionalism. The first of these heuristic maxims advises us to look for the explanation of social facts in the interplay of individual actions in varying circumstances; circumstances in which the scarcity of means for the fulfilment of human wants is an essential aspect of the state of affairs to be analysed, and in which the self-interest of the individuals is of decisive importance for the orientation of these actions. The second of these maxims, theoretical institutionalism, emphasizes the fact that these actions and, therefore, all social processes are canalized by the historically-variable institutional arrangements which function as incentives for them. That is to say, these actions are influenced by rules and norms which have factual validity in social life.

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<sup>9</sup> That norms are "social facts" is, of course, compatible with the negation of a "cosmos of norms" stated above, for it means only that people are influenced by normative ideas.

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This research programme requires at the same time the search for laws which make the explanation of social processes possible; explanations which take into account the historical variability of the conditions. Thus, this is a quite general conception consisting of a few simple ideas which is not restricted to particular social spheres or to particular historical periods: a general research programme for the social sciences, not restricted, in particular, to the "economic sphere" in the usual sense.

The central concern of this programme has always been the problem of social control or of social steering mechanisms. The first object of inquiry has been the market and its price mechanisms, but now we know that in principle all kinds of control systems can be analysed in this manner. And I think that the development of social science in the last decades has shown two things: (1) that it is necessary to go deeper into the analysis of institutional arrangements of all kinds and to broaden this analysis in order to get adequate models and explanations and (2) that the behavioral assumptions which belong to the core of the programme have to be revised for this purpose.

I cannot consider in detail the well-known deficits of economic thinking. Its main merit seems to be the fact that it is the only discipline in social science which aims at theoretically-founded explanations in a systematic way and is, therefore, in principle suitable to give results which are practically usable. For, if it is possible to explain social phenomena, then it is possible to influence them rationally to a certain degree.

### **V. Law and the Idea of a Rational Jurisprudence**

We come back now to the question of the practical use of social science, mentioned in the third part of this paper. I mentioned that it may be useful, in achieving this end, to transform the respective set of propositions into a technological system. If we consider the role of normative regulations in social life and the role they have in explanations of social processes, it is obvious to think of systems of social technology in which norms are treated as means for influencing social processes. In fact, norms are used in this way all the time: in legislation, in the making of constitutions, but also in other social activities which are directed at the establishment and reconstruction of organizations and other social arrangements.

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Now, as far as the norms of law are concerned, jurisprudence as the science of law seems to be competent in solving these problems. But if we examine jurisprudence as it is, we get the impression that it conceives of its task in an entirely different way. Of course, it leaves explanations to other disciplines, e.g. to history or sociology of law, because it is based on practical interests. It is normal for lawyers to conceive of jurisprudence as of a normative science, a science which produces normative statements. Since the law is not their own creation - jurisprudence has no competence for law-making - the only way out is the attempt to find norms which have been declared valid by social authorities which possess competence to make such declarations. And since the respective pronouncements in most cases are to be found in certain texts, the main task is the identification and interpretation of these texts with the aim of finding valid norms. Jurisprudence then seems to be a hermeneutic science which produces normative statements expressing valid norms, valid, of course, only in particular space-time-regions.

Prima facie, then, it seems to be the case that lawyers make attempts to grasp a "cosmos of pure norms" which are "valid" in a particular space-time-region. But what would be meant then by "validity"? If "validity" were to be understood as efficacy, this whole undertaking would boil down to a description of social facts and it would be misleading to speak of normative statements and of normative science. The complete formulation of the respective propositions would have to make clear that they describe social facts.<sup>10</sup>

Like in historiography, the identification and interpretation of sources would lead to the description of facts. And we would ask the lawyer, how far this kind of undertaking would be of any help to his practice. Of course, in fact, lawyers are not usually prepared to understand "validity" in this way. They generally see it as normative, as a claim to general recognition or acknowledgement which is to be distinguished from factual validity in the sense I have mentioned above, but, in spite of this, is in some obscure way dependent on factual conditions.

But the difficulties become even greater if we consider the fact that the existing texts in general leave a certain range open to interpretation and that they even have "holes", so that the idea of the completeness of the legal order seems to be problematic. This idea is, in fact, to be seen as a demand to produce this completeness by corresponding decisions. And judges are required to produce such decisions in any case.

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10 As Alf Ross has stated in his book: *On Law and Justice*, London 1958, p. 9.

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If jurisprudence has the task of helping legal practice with respect to these problems, it cannot be satisfied with the kind of hermeneutic procedure mentioned before. It has to supplement the norms taken from the texts with its own proposals. How this can be done has been a controversial question for a long time. For instance there has been major controversy in Germany resulting from the disagreements between representatives of "Begriffsjurisprudenz" (conceptual jurisprudence) and "Interessenjurisprudenz"(jurisprudence of interests).

To solve these problems, one obviously has to use standpoints which cannot be easily taken from the texts. The German lawyer Rudolf von Jhering speaks of a "productive task" of jurisprudence in this context in spite of the fact that it has no competence for creating law.<sup>11</sup> It is, therefore, not possible for jurisprudence to declare the norms which are proposed for filling the "holes" and completing the legal order to be "valid". Moreover, it would be implausible to treat these norms as "ends in themselves" or as "self-evident", for instance as components of a legal order which is given by nature or by God and to be understood by "intuition".

Normative regulations are usually introduced because of their factual consequences, that is to say the effects on the situation of the members of society which are to be expected from them. Since these regulations have the character of means, it is necessary for a rational argumentation to make explicit two things: (1) which ends they are expected to promote and (2) which effects they have. For, without investigations of this kind, it is not possible to find out how well the expected effects correspond to the ends to be reached and if there might be side-effects which may be incompatible with other ends or values which are presupposed in the analysis. But investigations of this kind require the use of nomological information as provided by the theoretical sciences.

I think I have shown that rational jurisprudence has to be seen as a kind of social technology in the sense of Max Weber and Karl Popper, one which has the task of constructing efficient norms, i.e., norms whose installation are, as far as we know, an effective means to the ends hypothetically presupposed. Part of this task, obviously, can be accomplished by an efficient interpretation of the text of valid law, presupposing the same points of view.

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<sup>11</sup> For the general conception of Rudolf von Jhering, see his famous book: *Der Zweck im Recht*, 2 volumes, 6.-8. ed., Leipzig 1923.

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Now, if we conceive of jurisprudence in this way, it is possible to conceive of problems of legislation and the problems of an adequate constitution as part of its task, as well as problems of the development of the legal order. If we come back now to the research programme mentioned above, we see that a theoretical social science of this kind could be the foundation of rational jurisprudence. Thus, constitutional political economics may be part of rational jurisprudence.

### **VI. The Problem of an Adequate Social Order**

We come back now to the problem formulated first by Thomas Hobbes more than 300 years ago. As is well-known, to solve this problem in a framework of naturalism, Hobbes made assumptions about human nature and about the human condition, assumptions leading to consequences for social life. In a thought-experiment he divided society into its components, the human individuals, and listed the laws which presumably determine their behavior. Then he tried to derive the social order which is required by these conditions. His fundamental assumptions were: self-interest determines individual behavior and the scarcity of goods is a typical situation, so conflict and competition is to be expected.

His solution is that peace, as a fundamental condition of an ordered social life, can be secured only if a monopoly of violence can be installed, controlled by someone fit for the task. The so-called "natural state" of Hobbes has to be seen as a marginal case which is, at best, approximately realizable, the result of an idealization as one can also be found in natural science. His causal laws have been formulated as hypothetical imperatives which are connected with the fundamental needs of man.<sup>12</sup>

He was the first thinker to develop a social technology aimed at solving the problem of an adequate social order. The regulative idea leading to this solution is the idea of securing peace. Lately in discussion, the Hobbesian assumptions have been partly called into question and modified, and further points of view or regulative ideas have been developed for the evaluation of the adequacy of social orders. Yet the mode of thinking introduced by Hobbes to solve the problem of the social order has been shown to be useful.

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<sup>12</sup> Cf. WATKINS, *ibid.*

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The scarcity of means as a central property of the human condition and the emphasis on the role of self-interest for human actions can also be found in consequent conceptions analysing the problem of the social order.

But in the discussion of this problem, the opinion that we need a normative science in the strict meaning of this word, i.e., a science which produces true normative statements expressing special kind of insights or truth, is most prevalent. This may be plausible because an "adequate" order seems to be an order which has to have certain good properties, i.e., properties required to make it acceptable, and that means to make it "valid" in a normative sense, analogous to "validity" in factual knowledge.

But, as may be recalled, I have criticized this view before and, in fact, the problem can be solved without recourse to such a kind of knowledge<sup>13</sup>. It can be solved in the framework of a social technology which applies the general method stated in the first part of this paper. A solution of this kind is preferable because the use of normative propositions of the above-mentioned kind would produce the impression that science is able to give insights of a normative kind which have the status of knowledge, i.e. it would produce illusions stemming from value-platonism.

I would not dispute the fact that one can discuss the requirements which are to be fulfilled by a social order rationally. But the analysis of the problem of the social order can largely be excluded from the results of such a discussion if one is prepared to transform the normative points of view, the value-positions taken as relevant by the participants of such a discussion, into performance characteristics of the respective social systems.<sup>14</sup> These performance characteristics are the criteria on which the comparative analysis of alternative social orders can be based. The point is to compare realizable systems of institutional arrangements with regard to their mode of functioning and with regard to the question as to whether they fulfill these criteria. That may be even more plausible because the participants of the discussion presumably use, in part, the same properties in evaluating these systems, but they may weigh them in a different way.

Independent of these differences, the comparative analysis of alternative orders can use all these properties objectively. It can make use of theoretical and historical knowledge to solve the problem of realization - the putting into

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13 As I have tried to show in my book mentioned in footnote 5, above, and in other places.

14 For the concept of a performance characteristic cf. RUTLEDGE VINING: *Economics in the United States of America*, UNESCO, Paris 1956, p.14f.



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effect - of the orders to be analysed. It can also show the real incompatibility of some combinations of performance properties. In doing so it can introduce the problem of costs into the debate about an adequate social order. It can, for instance, analyse how much of certain liberties has to be sacrificed to raise equality or safety, and so on.

The fact that people do not agree on values, therefore, does not make the scientific - and therefore value-free - analysis of the problem of social order impossible, not even when allowances for the different value-positions of the participants in this debate are made. In my opinion, the procedure proposed here would even make the rational discussion of these value positions themselves easier, for the concentration on real possibilities would show which compromises need to be taken into account at all, a point emphasized by Max Weber.

It would be easier for the individuals to decide for themselves which kind of social order would be acceptable if it is possible to make clear which kind of orders are realizable at all, and how well they fulfil the criteria which are relevant in their opinion.

Maybe unanimous agreement cannot be reached in this way, but James Buchanan's normative individualism is compatible with this kind of analysis. Such a solution of the problem of the social order is, in any case, compatible with the idea of rationality and the methodology of critical rationalism, whose representatives have shown that a solution according to classical rationalism has to be repudiated because it proposes utopian requirements and involves illusions about the character of the problem and about human possibilities.

## **6 A Creative Theorist in His Workshop: James M. Buchanan as a Positive Economist**

WILLIAM F. SHUGHART / ROBERT D. TOLLISON

- I. Introduction
- II. The Link Between Positive and Normative Economics in Buchanan's Work
- III. Buchanan's Positive Hypotheses
- IV. The Economist as Preacher
- V. Concluding Remarks

### **I. Introduction**

As one of our friends once said, James M. Buchanan is a whole university in and of himself, or at least an economics department, a philosophy department, and a political science department combined in one person. Another way of putting this is to recognize that Buchanan has contributed to numerous literatures inside and outside of economics, so that characterizing his work or his methodological approach in general terms can be a little difficult at times. Depending on the time and the particular issue he is pursuing, Buchanan appears here and there in a variety of methodological modes. It is fair to say, however, that in the main Buchanan has worked as a normative economist - he has tried to use economic theory to increase the understanding of complex behavioral interactions, so as to enhance general agreement on mutually beneficial social arrangements. He is not a welfare economist or a utilitarian in the sense that he offers any prospects of ascertaining what is "best" for everyone, distinct from their own evaluations. Rather, he is a contractarian who seeks to find the ways and means by which people might cooperatively better themselves. This, at least, is the aspect of his work that Buchanan emphasizes, and that other scholars have stressed as well.

This understanding of Buchanan, however, misses an important aspect of his work. Buchanan has made numerous contributions to positive economics over his career, which could easily be overlooked in the rush to interpret

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Buchanan as being primarily normative in research purpose. This essay seeks to redress this imbalance with a survey of his contributions to positive economics.

### II. The Link Between Positive and Normative Economics in Buchanan's Work

A prefatory word is in order about positive economics. Properly understood, positive economics ultimately involves the derivation of testable hypotheses about behavior, often preceded by careful elaboration of the logical consequences of initial postulates. There is no imperative that the positive economist actually test his theories. It is the insight that counts; the actual testing may or may not be left to others. Indeed, not all positive statements can be tested economically. Be that as it may, Buchanan is clearly not an empirical researcher. He has, in fact, been disdainful of econometric and empirical research on occasions. He has, nonetheless, made important contributions to positive economics which have increased our understanding of how the world works, and it is these contributions which are considered here.

It is often argued that positive statements are nothing more than thinly veiled normative arguments. This may or may not be the case, but accepting the point for the sake of argument, the converse would seem to be equally relevant - normative statements are nothing more than thinly veiled positive arguments. The analyst who says that the Congress *should* repeal the minimum wage law is also saying that the minimum wage law *is* the cause of teenage unemployment or, alternatively, that there *are* less costly ways of achieving given ends. Hopefully, this is not a conjuring trick, where, like Alice, up is down and down is up. Good normative theorists base their reasoning on good positive theories. In such a way, at least, we can derive the positive economics of Buchanan, from *both* his normative and positive contributions to the literature.

The approach taken will be to list, as succinctly as possible, the key testable propositions which can be found in Buchanan's work. Sometimes, this will amount to a simple declarative sentence with appropriate citations. The reader may consult the source of the propositions as his interests dictate. We will generally cite to a single source of an idea, and not to all incidences of the idea's occurrence in Buchanan's work. And, we may not have found the

original source of the idea but only a particularly clear exposition of it. Nonetheless, if we have done our job well, we expect that readers familiar with Buchanan's writings will pretty quickly recall the broader argument evoked by our brief summaries and, if interested, will be able to trace the lineage of the idea in Buchanan's writings.

Finally, the list will stick to Buchanan's original hypotheses to the extent possible. His repetition of standard economic ideas is obviously not to the point. Buchanan did not discover the law of demand, although a graduate student at the University of Virginia once tried to pass the Micro Prelim by attributing the law of demand to Buchanan and the law of supply to Warren Nutter, a fellow professor with Buchanan at Virginia.

### **III. Buchanan's Positive Hypotheses**

1. The Samaritan's Dilemma: Recipients of charity can exploit the dominance feature of donors' utility payoff matrices (Buchanan 1975b).
2. Academia: If you put the faculty in charge of the university, low-opportunity cost faculty will come to dominate university decision making, driving out the good scholars and lowering the productivity of the university; as a point of reference, one could examine the scholarly output of members of the faculty senate relative to non-member faculty in a given university (Buchanan and Devletoglou 1970).
3. Deficit Finance: If you lower the cost of taxing future citizens, they will be taxed at a greater rate (Buchanan 1958).
4. Keynesian Economics: Given a choice, politicians will vote for lower taxes and increased spending; the Keynesian "balance wheel" is loaded on the side of deficits; one of Keynes's legacies is modern deficits (Buchanan 1987a).
5. Tax Collection: Governments will collect as much tax revenues as feasible, given the constraints imposed upon them; Leviathan lives - the era of big government is not over (Brennan and Buchanan 1980).
6. Political Economy: The only test of right or wrong is uncoerced agreement among participating parties; there is no one "right" policy independent of individuals' evaluations (Buchanan 1959).

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7. Clubs: Many "public goods" are produced efficiently by private, cooperative arrangements; private supply of public goods is feasible in certain cases (Buchanan 1965a).
8. Voters: The individual's decision to vote in the ballot box differs from market choices because of the absence of the choice-consequence nexus (Buchanan 1954).
9. Institutional Analysis: The relevant comparison is between realized and not idealized institutional alternatives; government is not a free lunch (Buchanan 1962a).
10. Fiscal Federalism: Fiscal mobility of individuals and capital embodies certain potential social costs; "cities" do not function like private clubs because certain property rights are undefined (Buchanan and Goetz 1972).
11. Expressive Voting: Voters may be more virtuous in a 1/N setting by virtue of the first law of demand (Brennan and Buchanan 1984).
12. Ricardian Equivalence: Uncertainty over future tax liabilities leads people to prefer debt to taxes (Buchanan 1976a).
13. Work Ethic: Individuals have an economic self-interest in the ethics of others; the work ethic (as well as a saving ethic) promotes generalized increasing returns (Buchanan 1994a).
14. Public Choice: Man does not alter his basic behavior as between market and non-market settings; only the constraints are different (Buchanan 1979a).
15. Monetary Policy: Monetary rules and greater predictability of monetary policy are associated with a more prosperous economy (Buchanan 1962b).
16. Government Failure: Government is not a perfect instrument for correcting market failures (Buchanan 1962a).
17. Rent Seeking: The pursuit of transfers takes place in both public and private settings (e.g., the rat race); primogeniture will reduce rent seeking in families (Buchanan 1983).
18. Reform: We start from where we are (Buchanan 1962a).
19. Anarchy: The study of a world without government teaches us about the rational basis for steps to civil society and the consequences of a breakdown in social order (Buchanan 1972).
20. Tax Reform: "Reform" begets reform, as the tax code is auctioned off every so many years; rent seeking is a dynamic game (Buchanan 1987b).

21. Ethical Norms: Many ethical norms are the result of a long ago cost-benefit calculus suggesting the gains from trade from ethical behavior; ethics have economic value; ethics are a relatively absolute absolute (Buchanan 1965b).
22. Justice: Justice is fairness (Buchanan 1976b).
23. Secession: The ability to opt out produces fiscal benefits in a federal system; if at first you do not secede, try, try again (Buchanan and Faith 1987).
24. Monopoly: In some cases (crime, for instance) monopoly (e.g., the Mafia) produces social benefits (in a second-best sense) (Buchanan 1973).
25. Literature: The autobiographies of scientists are more truthful than those of novelists (Buchanan and Tollison 1986).
26. Economists: There are examples of "natural" economists, for example, Gordon Tullock (Buchanan 1987a).
27. Environmental Regulation: Interest groups prefer command and control regulation to emission fees, tradable pollution permits, and taxes (Buchanan and Tullock 1975).
28. Tax Earmarking: Tax earmarking produces fiscal outcomes superior to general fund budgeting; why should we buy public goods in fixed bundles (Buchanan 1963)?
29. Indirect Taxation: In a multiple period model of individual choice, there are conditions under which indirect is preferred to direct taxation (Buchanan 1966).
30. Generality Constraints: In majoritarian democracy, general rules that apply to all citizens inhibit majority cycling and rent seeking (Buchanan and Congleton 1998).
31. In-Kind Redistribution: There is an individualistic rationale for redistributing specific goods and services rather than general purchasing power (Buchanan 1968b).
32. Public Goods: The demand for public goods has a negative slope (Buchanan 1966).
33. Social Security: Employers do not "pay" the payroll tax (Buchanan 1990).
34. Fiscal Illusion: Politicians have an incentive to obscure the costs of government programs and to highlight the benefits of the same programs (Buchanan 1966).
35. Fiscal Awareness: Individuals are not very aware of how much they pay in taxes (Buchanan 1966).

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36. Ethics and Economics: Ethical behavior is muted by individual incentives in a large numbers setting; ethical behavior is subject to the first law of demand (Buchanan 1965b).
37. Majority Rule: Though widely used, this voting procedure does not have much to recommend it; combined, for example, with geographic representation, it leads to inefficient public policies (Buchanan and Tullock 1962).
38. Relative Unanimity: More inclusive voting rules increase collective decision costs but enhance the efficiency of collective decisions (Buchanan and Tullock 1962).
39. Unanimity: Unanimous agreement is the only voting rule consistent with discerning underlying increases in economic welfare (Buchanan 1962a).
40. Logrolling: Vote trading is analogous to private exchange in some respects in that it can enhance the productivity and stability of collective decision making under specified circumstances (Buchanan and Tullock 1962).
41. Constitutional Economics: The rules for in-period political exchange are a key source of the capital stock of any society; societies with better rules are more productive (Buchanan 1986).
42. Public Goods: In a small numbers setting, public goods will be provided efficiently on a voluntary exchange basis among individuals; in a large numbers setting individuals will pursue the potential gains from trade by selecting rules and institutions for the provision of public goods (Buchanan 1968a).
43. Profit Seeking: Profit seeking in competitive markets is not analogous to rent seeking; profit seeking creates value; rent seeking destroys value (Buchanan 1980).
44. Entrepreneurs: Entrepreneurs have positive and negative effects depending upon the institutional setting in which entrepreneurship is practiced (profit seeking versus rent seeking) (Buchanan 1980).
45. Socialism: An economic system which separates consumption from production will not survive (Buchanan 1997).
46. Democracy: This word must be preceded by "constitutional" if political equality is to be meaningful; democracy is not majoritarianism or mob rule (Buchanan 1997).
47. Bureaucracy: Bureaucracy is a system of political pricing that makes decisions based on criteria other than economic value (Buchanan 1994b).

48. Exit: The absence of an exit option in political processes blocks an important feedback loop to public decision makers (Buchanan and Faith 1987).
49. Science: Politics, unlike science, is not a search for truth; politics is about agreement (Buchanan 1967).
50. Market Orders: Outcomes emerge in ordinary markets from the process of individual choice; the end-state or allocative result has no meaning independent of individual choices (Buchanan 1982).
51. Valuation of Government Goods: If goods are given away freely, individuals will dissipate their value by over-usage (Buchanan 1968a).
52. Quantity Discounts: Monopolists secure more profit by introducing discounts on large purchases (Buchanan 1952-53).
53. Endogeneous Alternatives for Voting Choices: The alternatives presented for collective voting choices jointly depend on the voting rule (Buchanan and Tullock 1962).
54. Heterogeneous Inputs: In the presence of heterogeneous inputs a competitive input purchaser will behave like a perfectly discriminating monopsonist in purchasing bundles of heterogeneous inputs (Buchanan and Tollison 1981).
55. Relatively Absolute Absolutes: Something must be taken as given for purposes of analysis; there is a choice among choices and then choice itself (Buchanan 1989).
56. Economics: Economics is not about allocating scarce resources; it is about choice; it is also better than plowing (Buchanan 1979b).
57. The Welfare State: If the recipients of income transfers are allowed to participate in the collective decision concerning the size of the transfer, self-interested voting will bias transfers upward (Buchanan 1975a).
58. Public Finance: Fiscal policy outcomes can only be understood in the context of the budget as a whole; taxing and spending policies both have distributional consequences (Buchanan 1949).
59. Judges: Good law is the enforcement of agreed upon rules; social justice and law and economics are both about mutual consent (Buchanan 1974).



#### IV. The Economist as Preacher

George Stigler (1981) has argued that "preaching" by economists has had only limited influence on society and its decision makers. And by preaching, he simply means attempts to recommend the adoption of certain public policies or the practice of normative economics, e.g., suggestions that Congress *should* repeal the minimum wage law. When economists tell government things which clash with the preferences of underlying interest groups, it is true that such advice is usually ignored. Nonetheless, economics can (and has) serve(d) to elucidate both the positive economics and the social costs of public policies so as to in some sense make the transfers that prop up "inefficient" policies more naked to the natural eye. And, who knows, this baring of political motives may have played a significant role in economic reform, e.g., the military draft, deregulation, privatization, the fall of the planned economies, and so on. In truth, it is all but impossible to "test" Stigler's hypothesis.

The point about Buchanan and preaching is two-fold. First, Buchanan stresses agreement as the only means of evaluating the goodness or badness of a policy. Agreement is often facilitated by discussion and consideration of alternatives. In this sense the preaching of economists is merely participation in the marketplace of ideas. Buchanan sees this participation as both a right and an obligation, where his role is to convince others of the correctness of his views. The idea is not to impose views but to sharpen the alternatives and foster general agreement. This is the practice of positive political economy.

Second, and more related to this essay, is the point that positive economics plays a key role in Buchanan's political economy. If the minimum wage causes teenage unemployment, then this is a critical part of the discussion. Exposing the social costs of government transfer schemes may sway disinterested observers to see the policy for what it is, namely, a transfer of wealth to organized labor.

At a deeper level Buchanan wants to promote a dialogue about the rules of the game. Here, he also seeks agreement as the test of correctness, and he stresses the potential importance of the selection of rules to govern in-period politics. Preaching matters here because we are discussing permanent, long-term ideas for the operation of productive, healthy, and fair societies. Surely, the social marginal product of good ideas in this area is quite high because such ideas are quite scarce (as opposed to bad ideas). To wit, the scarcest commodities in this world are love and cooperation, and it is our task as

economists to see to it that their use is husbanded carefully by the appropriate institutional arrangements (Robertson 1956).

## V. Concluding Remarks

This essay stresses some of Buchanan's creative contributions to positive economics over the course of his career to date. But the message is broader than this. If agreement is the proper test, as it is in Buchanan, then his life's work can actually be seen as an exercise in positive political economy. At no juncture does he use his bully pulpit to tell people what to do. He makes proposals and suggests that if people thought about it, they would agree. This discussion and participation in the social dialogue is positive political economy at work.

Finally, we think the range and depth of the above list speaks for itself. Yet it is probably also incomplete. If the reader feels so moved and thinks that we have missed an important positive proposition in Buchanan's work, please feel free to let us know. To conclude, ask yourself the following question: would you find as rich and as varied a menu of ideas by going through the same exercise with other modern economists?

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## **7 Buchanan and Shackle on Cost, Choice and Subjective Economics**

STEPHEN C. LITTLECHILD<sup>1</sup>

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### **I. Prefatory Remark**

Thirty years ago, Jim Buchanan elucidated and developed the subjective nature of opportunity cost and its relation to choice. Ten years later, Jack Wiseman and I were hoping to write a textbook embodying a thorough-going subjectivist approach. Jim kindly offered to host our work at the Center for Public Choice, VPI, in Blacksburg in the summer of 1980. This was an invaluable opportunity: Jim's own understanding of and sympathy for the approach and his openness to discussion, as well as the active intellectual milieu and unfettered working conditions at the Center, made this an ideal environment. No matter how early we arrived in the office there would be a typed

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<sup>1</sup> Honorary Professor, University of Birmingham School of Business. I am grateful to Lawrence White for helpful comments on this paper; and to Ms. Kathleen Cann, Manuscripts Department, Cambridge University Library and Mr. Adrian R. Allan, University Archivist, and his colleagues at Sydney Jones Library, Liverpool University, for assistance in accessing the material referred to below.

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note from Jim on our desks, reflecting his even earlier morning thoughts on the discussions of the previous day.

Regrettably, Jack and I did not succeed in producing the subjectivist textbook. There were many difficulties. For example, Jack would propose that we could not use market demand and supply curves because they did not exist in anyone's head. I would counter that we could not realistically produce an economics textbook that did not contain such demand and supply curves. We would argue furiously for a week. The next week we would each concede, after due reflection, that the other was right. Then we would argue for another week from the opposite points of view. By the third week we were each back to our original positions. And so on. We wrote several drafts, and Jim kindly organised a small seminar to discuss them, but I'm afraid we never did get past chapter four. But we did later publish a paper on Cost, Choice and Political Economy as exemplified by the "real" Robinson Crusoe.<sup>2</sup> The material for that paper was first collected during our stay at the Center, and Jack drafted a later version of the paper during a subsequent stay at the Center, by then moved to George Mason University, in Spring 1985. Both Jack and I were always grateful to Jim for his support, friendship and stimulating companionship.

## II. Introduction

Chapter 2 of Buchanan's monograph *Cost and Choice*<sup>3</sup> traced the contributions of the economists at the London School of Economics. In an Appendix to that chapter Buchanan commented that Shackle's treatment of the decision process was consistent with the LSE doctrine although Shackle surprisingly did not make the linkage between his own work and that of his LSE counterparts. This stimulated some subsequent discussion as to whether or not Shackle's work was in fact consistent with the LSE opportunity cost tradition. The present note describes and evaluates some of this discussion and

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2 J. WISEMAN AND S. C. LITTLECHILD: "Crusoe's Kingdom: Cost, Choice and Political Economy", Chapter 7, in: STEPHEN F. FROWEN (Ed.): *Unknowledge and Choice in Economics*, Basingstoke (Macmillan Press Ltd.) 1990, pp. 96-128.

3 JAMES M. BUCHANAN: *Cost and Choice: An Inquiry in Economic Theory*, Chicago (Markham Publishing Company) 1969.

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seeks to clarify the issue by giving Shackle's own view on this matter, as expressed in Shackle's correspondence now available for study<sup>4</sup> and as set out in a hitherto unpublished note annexed to this paper. The paper concludes by recording an exchange of views between Buchanan and Shackle on subjective economics.

### III. Buchanan on Shackle and Cost

Buchanan comments as follows on Shackle.

... Shackle's treatment of the decision process is wholly consistent with the London doctrine of opportunity cost. Yet - and surprisingly - Shackle does not, to my knowledge, make the obvious linkage between his provocative and important work on decision, uncertainty, and time and the work on opportunity cost carried forward by his LSE counterparts. In his general treatment of cost itself, Shackle reverts to orthodoxy.<sup>5</sup>

To substantiate the first claim Buchanan gives excerpts from Shackle's *Decision, Order, and Time in Human Affairs*.<sup>6</sup> These illustrate Shackle's emphasis that the outcomes of actions between which a decision-maker chooses are things imagined by the decision-maker; that the consequences relevant for the decision-maker's choice are the experiences of the decision-maker, rather than experiences coming from outside; and that it is imagined outcomes at the time of decision, rather than actual outcomes observed later, that are relevant. In a later paper Buchanan asserts that

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4 STEPHEN C. LITTLECHILD: "Disreputable Adventures: The Shackle Papers at Cambridge", Chapter 14, in: PETER EARL AND STEPHEN FROWEN (Eds.): *Economics as an Art of Thought: Essays in Memory of G.L.S. Shackle*, London and New York (Routledge), 2000 (forthcoming). Letters to and from Shackle cited in this paper are generally to be found in this collection, at Add. MS 7669 in Cambridge University Library. Miss Kathleen Cann has prepared a helpful guide to the collection, reprinted in the above volume.

5 *Cost and Choice*, p. 36.

6 Cambridge (Cambridge University Press) 1961.



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Although Shackle does not specifically present his ideas in opportunity-cost terms, his whole approach to decision is fully consistent with that developed by the London theorists. Shackle was both directly and indirectly associated closely with the London group.<sup>7</sup>

### IV. White on Shackle and Cost

It was Buchanan's claim concerning the analytical relationship between Shackle's ideas and those of the LSE group that attracted interest. In the very first issue of the *Austrian Economics Newsletter*, Richard Ebeling took Buchanan's claim a stage further, and asserted in effect that Shackle did think of cost in opportunity cost terms. He wrote

G L S Shackle has argued that by its very nature choice involves uncertainty because of the imperfection of knowledge. All choices involve imagined possibilities that could occur. Thus costs, too, are the expected opportunities that the actor believes he would have to forego. These expectations are based on the subjective interpretations of the individuals themselves and have no existence outside the mind of the actor.<sup>8</sup>

In the next issue of the *Newsletter* Lawrence White explicitly rejected this suggestion, and claimed that "Shackle does *not* endorse the concept of opportunity cost". Rather, "It is [the] distressing prospect of loss which Shackle identifies as the cost accompanying choice." White's brief comment may usefully be reprinted in full.

Richard Ebeling's piece, "On the Theory of Costs" (*AEN* vol 1, no 1) is a terrific idea executed very well. As a student of

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7 JAMES M. BUCHANAN: "Introduction: L.S.E. cost theory in retrospect", Chapter 1 in: JAMES M BUCHANAN AND G.F. THIRLBY (Eds.): *L.S.E. Essays on Cost*, London School of Economics and Political Science (Weidenfeld and Nicolson) 1973, pp. 3-16; quotation at fn. 5 p. 12.

8 RICHARD EBELING: "On the Theory of Costs", *Austrian Economics Newsletter*, vol. 1, No. 1 (Autumn 1977). Reprinted in STEPHEN C. LITTLECHILD (Ed.): *Austrian Economics*, 3 volumes, Aldershot (Edward Elgar) 1990 (paper in vol. 1, pp. 253-4).

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Shackle's works, however, I feel it my duty to point out that Shackle does *not* endorse the concept of opportunity costs. His theory of decision differentiates between gains and losses, which is contrary to the doctrine of defining cost on an opportunity basis only. (Arrow pointed this out in "Alternative Approaches to the Theory of Choice in Risk-Taking Situations", *Econometrica*, vol. 19, no. 4 (Oct. 1951), p. 432) The decision-maker in Shackle's system does *not* choose a course of action because he *believes* that when its outcome is reaped his benefits will outweigh his opportunity costs. He does not have a positive belief in any of the imagined outcomes of any action, chosen or foregone. Rather he chooses that course of action which enables him most to enjoy, at the moment of decision, the prospect of future gain tempered by the prospect of loss. It is this distressing prospect of loss which Shackle identifies as the cost accompanying choice. In *Time and Choice*, the 1976 Keynes lectures in Economics of the British Academy, Shackle writes: "What the choosing of an action-scheme can do, is to make some desired imagined paths of history possible, in my subjective sense, at the *cost* of making some counter-desired imagined path also possible." (p. 13; my emphasis).

In sum, Shackle rejects the notion of opportunity cost because he denies the existence of well-defined opportunities in the decision-maker's imagination. A close reading of pp. 132-33 of *Epistemics and Economics* will show that Shackle is restating the doctrine of opportunity cost in order to discuss its inconsistency with the deterministic overtones of standard microeconomic theory. While the subjectivist interpretation of opportunity costs set forth by Ebeling is entirely reasonable, it cannot be found in *Epistemics and Economics* and should not be ascribed to Shackle.<sup>9</sup>

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9 LAWRENCE H. WHITE: "Comment on Shackle's Notion of Opportunity Costs", *Austrian Economics Newsletter*, vol. 1, no. 2 (Spring 1978), p. 10. Reprinted in STEPHEN C. LITTLECHILD (Ed.), *Austrian Economics*, op. cit., vol. 1.

## V. My Own View

I found White's argument intriguing but not convincing, though I considered that Shackle himself seemed to be inconsistent on usage. I drafted a note to the *Newsletter* which I did not subsequently publish but which I discussed in correspondence with White.<sup>10</sup> I pointed out that on page 61 of the volume *Expectation, Enterprise and Profit* Shackle used the term cost to mean money outlay, and in the same volume also used the term opportunity cost. He was discussing a seller choosing between two policies for dealing with a buyer. The 'possible breakdown' policy involved no concessions to the buyer; the 'possible loss of face' policy involved whatever concessions were necessary to secure agreement. Shackle wrote "The opportunity cost of adopting the possible breakdown policy is plainly the sacrifice of the best hope he (the seller) could have entertained under the possible loss of face policy, it is the hope that gain which, having regard both to its size and to the ease or difficulty of believing it attainable, is the most attractive possibility held out by the possible loss of face policy, it is in fact the focus gain of this alternative policy."<sup>11</sup>

He maintained and expanded on his view; I agreed (or thought I did) with his detailed arguments, but suggested that Shackle's approach could nonetheless be interpreted so as to fit into and generalise the LSE framework. Briefly, my suggestion was that the opportunity cost of a chosen action A was the value of the pair of focus outcomes associated with the rejected action B. I thought (erroneously) that White and I agreed as to the senses in which Shackle was or was not consistent with the LSE tradition.

In July 1978 the University of Birmingham awarded Shackle an honorary degree, and I took the opportunity to put my proposition to Shackle himself. He professed shock that he should be thought to reject opportunity cost and seemed to think his approach consistent with it. But as I confessed in my letter of 21 September to White, "You must understand, however, that Shackle invariably agrees with everyone, and one has to seek amongst delicate shades of enthusiasm to ascertain his real view."

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10 S. C. Littlechild: "Shackle on Cost", 6. June 1978 (unpublished manuscript, 2 pages), SCL to LHW 12 June 1978, LHW to SCL 12 September 1978, SCL to LHW 21 September 1978.

11 G. L. S. SHACKLE: *Expectation, Enterprise and Profit*, London (George Allen & Unwin) 1970, p. 146.

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On 25 September 1978 I invited Shackle to consider the matter explicitly. On 28 September he wrote back saying "On the question of opportunity cost, it is evident that I must really pay undistracted attention to this and sort out my thoughts by writing a short piece (for my own benefit)." Given his interest I copied to him White's letter to me of 12 September and summarised my own interpretation as follows.

In order for an action to be chosen it must be able to jump two hurdles. (1) Its focus gain must be sufficiently attractive to outweigh its focus loss. (2) This pair of focus outcomes must be sufficiently attractive to outweigh the pair of focus outcomes associated with any other action. We may then say that the cost of choosing any action is the value attached to the pair of focus outcomes of the second best action.<sup>12</sup>

### VI. Shackle's View on Opportunity Cost

On 7 November Shackle wrote back saying "I spent three weeks trying a variety of attacks on the question whether and how opportunity cost can be expressed in terms of focus-outcomes. In the end I merely convinced myself that your paper says everything. It seems to me that Lawrence White only differs from your view in leaving out the necessary second stage of comparison. I think his contribution has been very valuable in raising the whole question." He enclosed "the draft into which I sorted my ideas". Shackle's key conclusions are perhaps as follows.

The question which concerns me is what meaning is to be given to opportunity-cost when choice amongst enterprises [schemes of actions] ... is examined in terms of focus-outcomes.

The notion of opportunity cost expresses an extremely general aspect of choice. The sacrifice of a second-best is part of the

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12 SCL to GLSS 3 October 1978. (Unfortunately, I do not seem to have sent Shackle a copy of my note of 6 June 1978, which contained the example from his own writing, but this may also have meant that he was forced to consider the matter anew.

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essence of any act of choice. We may still, however, ask in what that sacrifice precisely consists. It must consist in that psychic experience, inferior only to the one he has elected, which was within his reach instead. If we represent both the elected and the foregone enterprise by means of pairs of focus outcomes, the psychic experience in each case is the enjoyment by anticipation of that course of things represented by the focus-gain, combined with the distress of contemplating that course of things represented by the focus-loss. ... [F]or his choosing one particular enterprise out of a number of rivals ... the chosen enterprise must have a focus-gain more persuasive than its focus-loss, and this excess of influence must be greater than that which is to be found in any rival. Two stages of comparison are needed: focus-gain with focus-loss in each of the two rivals, and excess of persuasive power in one case with excess of persuasive power in the other.

... We can step back, as it were, from the notion of opportunity-cost and look upon it as *one* necessary element in an act of choice, but not one having a right, in the nature of things, to be treated as the only one that matters. Cannot cost be a more complex idea than that of a single scalar quantity?<sup>13</sup>

I sent White a copy of Shackle's manuscript, and a couple of months later he wrote to Shackle, expressing surprise that his initial statement in the *Newsletter* was considered controversial. "I was under the impression that you had explicitly broken with the opportunity cost tradition on the grounds that a chancy opportunity cannot be assigned a single value *ex ante*.... Instead an uncertain prospect must be assigned an ordered *pair* of epitomizing values (focus gain, focus loss)."<sup>14</sup> He also expressed concern about the implications for the concept of the neutral outcome.

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13 G. L. S. SHACKLE: "Opportunity-cost and the concept of focus-outcomes", manuscript dated 22 October 1978 (6 pages). A copy of this manuscript is attached as an annex to the present paper.

14 LHW to GLSS 16 January 1979.

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In his reply to White, Shackle expressed very great admiration for a copy of a paper on entrepreneurial price adjustment that White had sent,<sup>15</sup> and suggested an additional reference to his own work. He continued, "I must in coming days enter upon a period of most intensive exertion, in order to come to terms with your searching criticism regarding opportunity cost. I must look at the whole matter again from the start."

In fact, Shackle did not write further to White on this topic. But three years later, he was asked about this issue by Alex Shand, who was then writing a monograph on subjective economics. His reply shows that he had not changed his view.

James Buchanan, being I think one of the originators of the *displacement cost* concept (opportunity cost concept) thought that I had rejected or neglected it when I said somewhere that exposure to the focus-loss of a proposed investment is the "price-paid" (in terms of feeling) by the business man for having the hope of the focus-gain. This idea is a description of the *internal structure* of the promise-and-threat represented by a proposed investment. Whatever attraction this investment has for him (possible gain weighed against possible loss) it will have to compete with other proposals which have a generally similar structure of promise and threat, and we can regard the attractions of one scheme as the "cost" (entailed sacrifice) of the other. There is really no clash between opportunity-cost and the view of focus-loss as the "price" of focus-gain, both of these being *imagined sequels deemed possible* of a specific present use of resources. The essence of the matter is that when we take proper account of uncertainty (which means *rivalry* of plural answers to one-and-the-same question) there is no longer a simple comparison of one sole profit-figure for one enterprise or investment with one sole profit-figure for another enterprise.<sup>16</sup>

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15 "You are like a swordsman of superlative skill and intrepidity successfully attacking a dozen simultaneous opponents and exposing their ineptitude. I am sorry you intend some 'toning down'. I do hope this glinting blade will be allowed to flash undulled." GLSS to LHW 17 February 1979.

16 GLSS to AS 11 November 1982.

## VII. Evaluation of Buchanan's Views

Buchanan was right and perceptive to observe that many of Shackle's statements on decision were consistent with the subjective cost discussions of other LSE economists. This was a novel and stimulating claim, which predated some of Shackle's more explicit writings in this vein. For example, it was not until four years after *Cost and Choice*, and after Buchanan had written his paper on "LSE Cost Theory in Retrospect", that Shackle's argument was published that

"the purpose and the proper criterion of a choice of conduct is to afford the chooser, at the moment of choosing, a good state of mind. The orthodox view is different. ... Choice is necessarily amongst thoughts, amongst things imagined."<sup>17</sup>

This quotation further tends to confirm Buchanan's suggestion about the acceptance of the subjective concept of cost in London and the lack of acceptance elsewhere.

How far "Shackle was both directly and indirectly associated closely with the London group" is less clear. Hayek was Shackle's Ph.D. supervisor at LSE, and Shackle was very familiar with Hayek's economic thinking, though he later decided to work on Keynes' ideas instead of Hayek's. And, as Buchanan notes, Thirlby acknowledged the influence of Shackle and indeed notes that Shackle read and commented on one of his papers in draft.<sup>18</sup> But Shackle was very much a loner, not associated closely with any group. He often wrote of the impact that particular economists and ideas had on him, but I am not aware that he wrote of his London colleagues in this way.

The Shackle papers at Cambridge shed further light on the issue.<sup>19</sup> Shackle reviewed a couple of Robbins' books and there is evidence that he

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17 G. L. S. SHACKLE: *Epistemics and Economics*, Cambridge (Cambridge University Press) 1972, pp. 123, 130. The volume in which Buchanan's paper appeared was published on 28 June 1973 but his paper was written over the period 7–10 June 1972 and sent to the publisher on 15 June 1972. (I am grateful to Betty Tillman for this information.) The publication date of Shackle's book is given in the book as 1972, but in fact it was not published until 1 February 1973.

18 G. F. THIRLBY: "The economist's description of business behaviour", *Economica*, (May 1952), at footnote 24 (reprinted in *LSE Essays on Cost*).

19 See LITTLECHILD, "Disreputable Adventures" fn. 3 above.

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read carefully a 1938 paper by Robbins on methodology (and mysteriously deemed it "very badly spelt"). There was one exchange of letters with Robbins, in December 1968, associated with Robbins' Festschrift, in which Shackle refers to Robbins' influence and to his lectures on the history of economic thought. Shackle also corresponded with Thirlby in December 1951, commenting on one of the latter's papers. This seems to be the reference acknowledged by Thirlby above, and there does not seem to be any further correspondence. Wiseman wrote to Shackle in October 1952, about "the probability bogey" and "excludable and non-excludable hypotheses", and sent him a copy of his article on uncertainty, costs and economic planning (reprinted in Buchanan and Thirlby *LSE Essays on Cost*). Correspondence between these two continued until 1990, as well as meetings. And if Wiseman did not raise the subject of subjective opportunity cost at some stage, he was not the Jack Wiseman that Jim and I knew. There is no evidence that Shackle corresponded with the other members that Buchanan identifies as in the LSE group, such as Coase and Edwards.

Given the deliberation with which Shackle approached every book and article, the scope of his reading programme was necessarily limited. For example, Shackle himself says that he did not read anything by Popper until much later [than it was written]. If this was true despite the importance and topicality of Popper at the time, and given the focus of Shackle's interests on business cycles and related issues, my initial inclination was to be surprised if he had read much by the LSE writers on cost. But the evidence now suggests that he must have been familiar with the thinking of Thirlby and Wiseman in 1951, and so I conclude that Buchanan was right in his judgement.

Buchanan suggested that "in his general treatment of cost itself, Shackle reverts to orthodoxy" but did not give sources to substantiate this claim. My note of 6 June 1978 drew attention to Shackle's *Expectation, Enterprise and Profit*, which in some respects is orthodox. White quite reasonably pointed out that "this textbook is, among Shackle's writings, the least expressive of Shackle's own views."<sup>20</sup>

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20 LHW to SCL 12 September 1978.



### VIII. Evaluation of White's Views

At the time of writing (1978), White was right to point out that (with apparently one exception) Shackle did not explicitly endorse the concept of opportunity cost, at least in his published writings, and that it was the distressing prospect of loss that Shackle identified as the cost accompanying choice. That was what interested Shackle, and what he focused on.

Furthermore, it would seem that Shackle had not at that time fully considered the meaning and implications of opportunity cost within his own system of thought. But I think it was going too far to claim that Shackle actually rejected the notion of opportunity cost. White cites Shackle's exposition of the doctrine of opportunity cost (what he calls displacement cost) in *Epistemics and Economics* (1972 pp. 132-3), and suggests that Shackle was doing so in order to discuss its inconsistency with the deterministic overtones of standard microeconomic theory. I am not confident that I know what Shackle's purpose was in that particular passage. He seems to be saying that opportunity cost and freedom of choice, and more generally rational conduct, can only be made consistent with a deterministic world if the relevant data are somehow provided to decision-makers (and that economists had failed to explain how this was done). But whichever interpretation is taken, it does not seem to be a rejection of opportunity cost; rather, it seems to be a rejection of standard microeconomic theory. And if it is not an explicit endorsement, it perhaps is an implicit endorsement of opportunity cost, and of the associated reality of choice in a world where knowledge is necessarily incomplete, if the alternative option is to accept standard microeconomic theory.

When Shackle's attention was drawn to the issue, he concluded that his own approach was not inconsistent with the concept of opportunity cost. (Nor, in effect, with Ebeling's characterisation.) He argued, essentially, that when uncertainty was fully acknowledged, and what he liked to call a skein of possible outcomes had to be envisaged for any action, then the concept of opportunity cost had to be defined more generally than economists had done previously. It had to be expressed in terms of the value associated with a foregone *skein* of envisaged possible outcomes rather than with a single envisaged outcome.

Because Shackle came to this question only after developing his own apparatus of decision-making, he did not express it in quite this way. He started from the proposition that each skein could be reduced to a pair of outcomes,

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namely the focus gain and focus loss. For an action to be attractive its focus gain had to be more persuasive than its focus loss. And for it to be more attractive than all other actions the excess of this persuasive power had to be greater than for any other action. In this latter sense the concept of opportunity cost was taken on board, but only as one of two hurdles that a chosen action had to overcome.

White's main objection was that Shackle had rejected opportunity cost because he denied the existence of well defined (i.e. single valued) opportunities, and instead proposed that actions be characterised in terms of a pair of focus-outcomes. If focus gain and loss are measured in relation to a neutral outcome, which may be hypothetical and not necessarily in the decision-maker's choice set, and if decisions are made on the basis of these concepts, White suggests that this is inconsistent with straight opportunity cost doctrine which ranks alternatives only relative to one another. I would again argue that "rejected" and "inconsistent" are too strong here. The criterion of focus gain exceeding focus loss is just one part of the test for a chosen action. Even Shackle's early expositions accept the need to choose between alternative available actions, on the basis of what he called the gambler indifference map.

White also expressed concern that Shackle was, in effect, reducing courses of action to single values at the final stage of decision, by characterising each action in terms of the numerical difference between focus gain and loss, and then comparing these differences and choosing the action with the greater difference. But this is not what I interpret Shackle to mean. He uses phrases like "ascendancy" and "persuasive influence" that mean more than simple subtraction of numerical amounts: they take account also of the degree of interest or excitement or concern generated by a each particular outcome and of its likelihood or plausibility. For an individual to choose an action, or enterprise, "because its focus gain more decisively overpowers its focus loss than is the case with any of its rivals" seems to me consistent with "retaining in the whole act of decision a formal role for uncertainty".<sup>21</sup>

I see force in several of White's concerns about the concept and definition of the neutral outcome. But they seem to me a problem for the concept and definition of a neutral outcome, rather than for the concept of opportunity cost within Shackle's world of uncertainty. I am not sure that the analysis and

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21 G. L. S. SHACKLE: *Decision, Order and Time*, p. 156, as quoted by White to Shackle, 16 January 1979.

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exposition of focus outcomes needs to refer to neutral outcome at all. Furthermore, Shackle's more precise propositions concerning reduction to and choice between focus outcomes seem to me essentially empirical ones and less convincing than the more fundamental concepts of the skein of possible outcomes and the interrelated relevance of attractiveness and subjective belief.<sup>22</sup> I am sure that Shackle would have approved of empirical work in psychology to try to learn more about how decisions actually are taken.

### **IX. Buchanan on Shackle and Subjective Economics**

This paper began by quoting Buchanan's 1969 comments on Shackle's work on subjective cost and choice. A dozen years later Buchanan again cited Shackle on subjective economics, in a very supportive way. For example, towards the end of his paper on the domain of subjective economics, he wrote

We must acknowledge that in many aspect of their behaviour, men conform to laws of behaviour such that such behaviour becomes subject to scientifically testable prediction and control through the external manipulation of constraints. But we must also acknowledge that men can choose courses of action that emerge only in the choice process itself. Men create value by the imagination of alternatives that do not exist followed by the action that implements the possibilities imagined. ...

In my view, no economist other than Shackle works exclusively within the domain of subjective economic theory, as I have defined it here.

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22 Shackle's friend Professor (now Sir) Charles Carter has made cogent arguments along these lines. See for example his papers "On Degrees Shackle: or, the Making of Business Decisions", in: C. F. CARTER AND J. L. FORD (Eds.): *Uncertainty and Expectation in Economics*, Oxford (Basil Blackwell) 1972, pp. 30-42, and "George Shackle and uncertainty: a revolution still awaited", *Review of Political Economy*, Vol. 6, No. 2 (April 1993), pp. 127-37.

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Any methodological advance must build on the work of Shackle.<sup>23</sup>

## X. Shackle on Buchanan

Having examined Buchanan's views on Shackle, it is of interest briefly to explore Shackle's views on Buchanan. He reviewed very favourably Buchanan's *Selected Essays on Fiscal Theory and Political Economy*<sup>24</sup>, particularly his study of the Italian tradition with which Shackle was especially familiar.

The annotations on Shackle's copy of the book enable us to see some of the thoughts that did not make it into print.<sup>25</sup> For example, he thought that at one point in his paper on the Italian tradition Buchanan fell into the same fallacy – consideration of partial effects – that he had been arguing against. But against this there are numerous passages marked with approval for quotation, one marked "a good paragraph", another "excellent" and in one case "a brilliant passage".

The annotations also reveal, in a way that the review does not, Shackle's sympathy for Buchanan's emphasis on subjectivism (though I'm not sure that either uses that actual term) in the context of welfare economics. For example, Buchanan writes

"To the individual decision-maker the concept of an 'efficiency criterion' is a useful one, but to the independent observer the pitfalls of omniscience must be carefully avoided. The observer

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23 JAMES M. BUCHANAN: "The Domain of Subjective Economics: Between Predictive Science and Moral Philosophy", Chapter 2 in: ISRAEL M. KIRZNER (Ed.): *Method, Process, and Austrian Economics: Essays in Honour of Ludwig von Mises*, Lexington, Massachusetts and Toronto (Lexington Books, D. C. Heath and Company) 1982, pp. 7-20, at pp. 17-18.

24 JAMES M. BUCHANAN: *Fiscal Theory and Political Economy: Selected Essays*, The University of North Carolina Press, Chapel Hill (Oxford University Press) 1960. Reviewed in *Economica*, vol. 30, no. 120 (November 1963), pp. 420-422.

25 Shackle Papers in the Department of Special Collections and Archives, Sydney Jones Library at Liverpool University, reference LXIII 19.

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may introduce an efficiency criterion only *through his own estimate of his subjects' value scales.*"

This passage gets Shackle's "excellent" rating.

The availability of the Shackle collection of letters at Cambridge now enables us to learn Shackle's views on Buchanan's later work. He was tremendously impressed and pleased with the latter's paper in the Mises symposium just cited. In his letter to Shand that covered opportunity cost (11 November 1982) he also commented, "I think James Buchanan is nowadays more pleased with my views than he was in *Cost and Choice* since he was kind to me in the paper he wrote for the Ludwig von Mises symposium last year." In the present Festschrift it is appropriate and pleasing to end with the tribute that Shackle wrote to Buchanan himself.

Dear Professor Buchanan,

I have just this morning received and read your paper on "The domain of subjective economics." I think it equal in its clarifying power to the greatest insights of theory of the last fifty years. I am thinking of such ideas as *ex ante ex post* and liquidity preference. Like these, your idea by a brilliant union of subtlety and simplicity strikes fetters from our thought. Your paper will be a classic once-for-all dissolver of confusion. It is a masterly incision of intellectual surgery. You have shown invincibly that the two domains, the subjective and the predictive, are mutually exclusive and must be kept wholly distinct from one another. Your argument proceeds in a manner deserving to be called majestic. Step by step the notions and methods essentially belonging to one domain but found occupying the other are removed to their proper place. What scientific economics, of its essential, inherent nature *cannot do* and *must not attempt* is shown inexorably. It cannot and must not be used to predict and therefore cannot be used to advise. I have never volunteered economic advice, but I have not attained or expressed the logic of total distinction and difference of nature of the two domains with any approach to your absolute clarity. I have felt an ever more compelling conviction that the world of thought contains everything that gives significance to choice, value and action. Economic theory has been transformed, or bodily shifted, from being about *things* to being about *thoughts*. ...

STEPHEN C. LITTLECHILD

I come to the end of my letter. How can I give you any conception of the feeling wrought in me by the last section of your paper? It is said that we live our span of life for the sake of a few glinting, gleaming golden threads in a homespun fabric, brief glimpses of entire felicity. You have given me one such.

I send you my utmost gratitude, my very best thoughts and wishes,

Yours sincerely,

G.L.S.Shackle<sup>26</sup>

## Appendix

### Opportunity-Cost and the Concept of Focus-Outcomes

G.L.S. Shackle

22 October 1978

Let us refer to a scheme of actions directed to some self-consistent unified effect, which actions and individual might envisage taking in his early time-to-come with the means at his disposal, as an *enterprise*. With these same means, any one but only one of a plurality of rival distinct enterprises will seem open to him. How will he decide amongst these enterprises?

If he looks upon such an act of choice as having in its making some element of uncause, so that its character could not have been inferred from any knowledge, however complete, of the circumstances and thoughts of the individual antecedent to its making, then he is obliged in logic to recognize that the sequel of any enterprise cannot be uniquely foreknown. For this se-

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26 GLSS to JMB 8. July 1981. It is satisfying to record that Buchanan reciprocated the testimony. In replying to an invitation to participate in a conference in Shackle's honour, he wrote, "Shackle is one of the most underrated persons in economics, and someone who richly deserves all honours." (JMB to Dr. S. F. Frowen 4 May 1983)

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quel will be shaped in some degree by the choices which he and others will make in time-to-come, and the character of these choices is not capable of being inferred. Nonetheless, his knowledge of natural principles, of human organization and of the posture of things in his present, including the qualities and quantities of his own resources, will seem to set bounds to the diversity of the sequels which, up to some moment in the course of his business of choice, he can imagine and judge possible for some specified enterprise. These sequels will be capable of being ordered by him according to their greater or less desiredness. If all of them are judged by him *equally* possible (equally free, in his thought, from fatal obstacles discernible by him in the light of his knowledge) only the most and the least desired will concern him. For all of the imagined sequels are *rivals*, the coming-true of one would exclude the coming-true of any of the others, there is no meaning in any summing or averaging of these mutual exclusives, what matters to the individual is what according to his judgement can follow his election of a particular enterprise, *at best and at worst*. These are what I mean by the focus-outcomes of the enterprise.

The concept of focus-outcomes takes a sharper edge if we apply it to some concrete and particular field of decision, since this makes it easier to treat the desiredness of a conceived sequel of action as a scalar variable. If this field is that of enterprise in the commercial sense, the setting-up and equipping of a business, then the relevant aspect of any sequel is the trading profit derived from the working of the business, that is to say, the excess, in each unit calendar interval, of the sale-proceeds of product over the expense of operation. As an element in decision, such a stream of trading profits is a supposition, something conceived in thought, one of many or indefinitely many rivals. In order to give it a scalar value, its instalments must each be discounted at that market rate of interest on loans which applies to the length of deferment of the particular instalment. The sum of these discounted or 'present' values will be the spot cash equivalent of the supposed stream of trading profits when the latter is considered in abstraction from its epistemic standing. Instead of a skein of conceived sequels the individual can now consider the set of their respective discounted values. The extremes of this set will provide the focus-outcomes. Thus we can resrepresent each enterprise which the individual envisages as open to him to choose, as a point in a Cartesian frame.

In this frame let the west-east axis serve for focus-loss and the south-north axis for focus-gain. Points in the north-east quadrant will stand for

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enterprises to which the individual ascribes focus-gain and focus-loss both of them numerically greater than zero. A point in the north-west quadrant would stand for an enterprise to which the individual adjudged a focus-loss numerically less than zero. That is to say, the enterprise would be assigned two focus-outcomes, both of them gains. No use need be made of the south-east or south-west quadrants. In choosing amongst several enterprises, each requiring the investment of one and the same value of resources, the individual will disregard any enterprise whose focus-gain is smaller, and whose focus-loss is numerically larger, than those of one of the other enterprises which he has in mind. His relevant comparisons, that is to say, will be only between such points as lie north-east and south-west of each other.

The expression *opportunity-cost* names the idea that when faced with a number of mutual exclusives amongst which he is free to choose, the individual in electing one of them is sacrificing the next-best of the choosables, and that it is this sacrifice which for him is the cost of the choice he actually makes. The question which concerns me is what meaning is to be given to opportunity-cost when choice amongst enterprises, in the more general or in some more special sense, is examined in terms of focus-outcomes.

The notion of opportunity-cost expresses an extremely general aspect of choice. The sacrifice of a second-best is part of the essence of any act of choice. We may still, however, ask in what that sacrifice precisely consists. It must consist in that psychic experience, inferior only to the one he has elected, which was within his reach instead. If we represent both the elected and the forgone enterprise by means of pairs of focus outcomes, the psychic experience in each case is the enjoyment by anticipation of that course of things represented by the focus-gain, combined with the distress of contemplating that course of things represented by the focus-loss.

May we not say that when our particular individual envisages that enterprise, amongst those which his own thought has created and judged possible, and has offered for his choice, which appeals most to him, he does so because its focus-gain more decisively overpowers its focus-loss than is the case with any of its rivals? What he sacrifices, as the cost of choosing the best enterprise, is this lesser ascendancy of the focus-gain of the second-best over its focus-loss. What, then, will express completely the formal necessary conditions for his choosing one particular enterprise out of a number of rivals? The chosen enterprise must have a focus-gain more persuasive than its focus-loss, and this *excess* of influence must be *greater* than that which is to be found in any rival. Two stages of comparison are needed: focus-gain with focus-loss



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in each of the two rivals, and excess of persuasive power in one case with excess of persuasive power in the other. And at last, can we say that one of these stages and not the other is opportunity-cost?

The matter can be penetrated a little further. We can step back, as it were, from the notion of opportunity-cost and look upon it as *one* necessary element in an act of choice, but not one having a right, in the nature of things, to be treated as the only one that matters. Cannot cost be a more complex idea than that of a single scalar quantity? However, we might be tempted to seek to restore simplicity by asking, if the *excess of persuasive influence* of focus-gain over focus-loss in one enterprise is greater than in another, *how much* greater is it? Here also, we need not be intimidated by traditions of exactness. Can we deny meaning to such expressions as 'distinctly greater', 'decisively greater', 'excitingly greater' which the individual might read from a private scale built up by his own experience and intuition. These may be deemed to hang between qualitative and quantitative assertion. But choice between enterprises is not a question of small differences. One exceedingly complex whole is almost of necessity *discretely*, not continuously, different from another. Men do not fall in love according to a calculation of marginal advantage. Thus I think we may eschew any resort to the invention of a (metrically defined) surface whose arguments would be the focus-gain and focus-loss variables represented on the axes of our Cartesian diagram. A private scale can be imagined to make such a surface conceivable. But what purpose would be served?

## 8 The Art of the State, State of the Art

HARTMUT KLIEMT

James Buchanan's constitutional political economy is much closer to what the philosophers of classical antiquity called an "art" than to what the philosophers and practitioners of modern times would call a "science". Buchanan has sometimes spoken of the scientifically-minded statistical endeavors of modern social science pejoratively as "proving that water flows downhill". Nevertheless, Buchanan would think of himself as "slipping down the hill" if he ever accepted the anti-empiricism and a priori methods of Ludwig von Mises and some of the more extreme Austrian economists. There is empirical content in economics but it is more or less as trivial as the empirical content of insights like "water flows downhill".

Obviously, within the modern scientific mindset, such views are not exactly regarded as "state of the art". On the other hand, some social philosophers cum philosophers of science like Sir Karl Popper, at least in some of their writings, have come very close to such views. That this is so does not necessarily make those views right. However, it is in itself quite significant that an eminent empiricist philosopher of science like Karl Popper would go that route as well. Still, the basic outlook underlying the Buchanan enterprise is presumably much closer to the concept of an art as endorsed in classical antiquity than it is to any notions in the modern philosophy of science. We are talking about a method which, at least in a way, claims to unite the normative outlook with the descriptive and explanatory one.

To be a political economist in the Buchanan sense does not amount to being objective or impartial – at least not in the modern sense of those terms. First of all, there is the Strawsonian claim that we always have to adopt a participant's as opposed to an objective attitude towards other human beings if we intend to be political economists in the true sense of that term. We hold other human beings responsible for their deeds, we treat them with resentment or gratitude, but we do not look at them simply as objects of strategic manipulation on whom we try to exert some causal influence as seems fit to reach our ends, aims or goals.

Secondly, there is a stronger normative claim involved. Buchanan clearly goes beyond Kantian norms of inter-individual respect as proposed by the

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Strawsonian perspective. Like in some of the paradigm arguments of classical antiquity which related the concept of an art to that of the pursuit of the good life Buchanan, without using the term "art", as a matter of fact treats political economy in general and constitutional political economy in particular as if they were arts in the classical sense. Even though Buchanan has frequently stated that he does not aspire to "save the world", he nevertheless is firmly located in the camp of those economists who intend "to make the world a better place". At least politically the world is a good place if individuals can pursue their own projects of the good life. This is the liberal element in Buchanan. But there is a communitarian element involved, too. That the pursuit of the good life should take place under conditions of interpersonal respect is a and perhaps the only genuinely common project.

The acceptance of this common project is presupposed as a tacit value premise guiding the whole enterprise of Buchanan-type political philosophy and political economy. He is quite willing to accept that not all share his vision or creed yet in the last resort he is only talking to those who do. This has a quasi-religious ring to it. But, clearly, Buchanan does not conceive of himself as a preacher, nor does he intend to become one of those quasi-religious "teachers" whose "teachings" become important simply because they originate from the "master". In a more moderate sense of the term "teaching", it would not be a mistake, however, to describe Buchanan's intentions as "teaching the art of politics".

Buchanan's art of politics, like any other art in the classical sense of that term, is concerned with "the good life". Contrary to the classical teachings of the art of politics, Buchanan does not address any elite of wise or powerful men. He is by no means an advisor to any sort of benevolent despot. The addressee of the advice is rather the citizen or, more precisely, any individual citizen. It is no accident that "The Calculus of Consent" has the subtitle "The Logical Foundations of Constitutional Democracy". We are talking about democracy quite in the sense of the "demos" being the author of politics rather than about majoritarianism.

Whether or not "logic" is the right or rather a misleading term may be left open here. But about the meaning of "constitutional democracy", there cannot be much doubt in this context. We are talking about the people expressing themselves within the limits of their constitution. But we are also talking about "the people" as author of their constitution. At least conceptually and ideally, Buchanan addresses everyone with his teachings in constitutional political economy. Each and every individual in her/his capacity as a citizen

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needs to know about the art of the state or about framing a state such that the good life becomes viable for the citizens of that state. Political economy is this art, not the maximization of a welfare function or something like this.

As is obvious from the preceding remarks, the art of the state is a very old one. Aristotle would be the classical proponent and Adam Smith, arguably, the most important modern one. Even though some cautionary remarks might be in order here, Macchiavelli and Hobbes would be members of the more scientifically-minded group of political theorists who adopt a more or less objective attitude. They can well suggest hypothetical imperatives of prudent behavior. However, their suggestions are, in the last resort, neutral or open to the several purposes individuals might have. As opposed to the former the latter theorists are not "artists" in the sense of being bound to some over-reaching values.

As far as certain fundamental ingredients of the good life in a polity are concerned, the Buchanan enterprise has never been simply neutral or an all-purpose list of technological norms relating means to any ("given") ends whatsoever. *Buchanan-type political economy has its own constitution that imposes constraints on what is admissible.* It is an art which is in itself bounded to certain ends, aims or values. Among those ends, aims or values, norms of inter-individual respect and a general aversion to any form of coercion play a most prominent role. And insisting on agreement is the way to express these convictions.

Like in medicine which is an art guided by the individual weal of the patient, political economy must be guided by some notion of the commonweal. And the analogy between medicine and political economy goes even further. For, like in medicine where the doctor is not supposed to impose his own specific values on the patient, in political economy, the political economist is not supposed to impose his own values on the community at large. As Buchanan says, the political economist is not an "economist who plays God". One might, in fact, in part answer the famous question, which happens to be the title of one of his most widely read papers, "What Should Economists Do?" by saying that "economists should not play God".

This is not to say, however, that the Buchanan-type of political economist would lend his advice to the pursuit of any values whatsoever. Political economy is not about getting one's way unboundedly, but rather about getting one's way within limits. On the ultimate justificatory level, a concept of bounded rationality is operative. For the rational pursuit of aims, ends or values of individuals is always bounded to the fundamental values of inter-

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personal respect. The norm of respecting other individuals on equal terms is constitutive for Buchanan-type political economy in general and constitutional political economy in particular. All arguments are constrained or bounded by norms of inter-individual respect. On the level of theory formation, constitutional political economy is in no meaningful sense of that term "value-free". It is rather bound to values like not imposing values on others, not even looking for means to that end. It is bound to letting others engage in their own pursuit of happiness, minimizing coercion and maximizing the independence and autonomy of each and every single individual as towards others while facilitating inter-individual co-operation in mutually-agreeable acts of bilateral or multilateral trade.

These are all values and, for that matter, liberal values in the classical sense of the term "liberal". Since Buchanan obviously sensed out early on in his career that rendering such values constitutive for an allegedly "scientific" endeavor was not exactly in-line with the rather positivist spirit of modern science and, in particular, of the science of his time, he simply attempted to fit it into the modern mindset anyway. For me, this explains why Buchanan in his more unguarded moments tends to argue as if committing the rather obvious blunder of assuming that meta-ethical non-cognitivism implies material norms of inter-individual respect as expressed by his insistence on the norm of agreement. But the meta-ethical thesis that we cannot know what is right or wrong normatively in the same sense in which we can tell right from wrong in the realm of facts is itself a "descriptive" thesis about facts. It is not in itself normative and, therefore, cannot imply a norm if only for the simple Humean reason that there is a gap between "is" and "ought" (the Prior-Mavrodes argument not being relevant here). Moreover, giving it second thought, the argument is not even persuasive on a systematic level. For, in particular, if it is not possible to know what is right or wrong independent of aims, ends or values which must be presupposed, why not simply go with one's own aims, ends or values and pursue them no matter what, rather than pursue them within limits as imposed by norms of inter-individual respect?

The person who does not believe in objective value judgements has any reason to impose her or his own subjective views on others. Within a purely subjectivist framework exerting an externality on others is fine for the actor as long as the actor can get away with it.

The normative presumptions of constitutional political economy in the Buchanan sense of that term cannot be justified on the basis of some epistemological thesis that would reject the scientific status of ultimate value

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judgments. The conclusion clearly is that Buchanan-type constitutional political economy is more an art in the classical philosophical sense than a scientific endeavor of the positivist kind. It is neither the same thing as non-practical science – empirical or theoretical – nor is it practical in the narrow sense of modern so-called applied sciences like engineering. – But is the art of the state state of the art?

Within the modern scientific mindset, engaging in an art is clearly not state of the art. Even in the applied sciences, we are drifting away from the notion of an art. For example, in medicine, in which – at least officially – some of the old values are supported, they are eroding in practice; good medicine is no longer defined independently of the patient's specific or particular aims, ends or values. The doctor's role is increasingly reduced to that of an auxiliary who is subservient to the arbitrary wishes of patients. With respect to medicine, one might think that this is as it should be. And I am quite tempted to think that way. With respect to political economy, I am much more reluctant. There seems to be something wrong with the notion that the political economist can counsel both the dictator or tyrant and/or the citizens who desire to organize themselves to their mutual advantage. I think that Buchanan's art of the state is state of the art exactly because he went against the current of the times and defined what the state of the art is. A noble achievement, indeed.

## 9 Buchanan as a Conservative

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Buchanan sees himself as an economist and for that reason a theorist of choice. He is attracted by individual sovereignty, calculative rationality, revealed preference, catallactic process, voluntary contract. He is repelled by top-down authoritarianism, social welfare functions, intolerant ideologists, Hegelian organicists and paternalistic leaders who tell the consumer in the Shop of State which 'public interest', which 'truth', which 'good society' he ought to buy. Buchanan sees himself as an economist and for that reason a student of the future: 'We can act only now: we cannot act in the past.' (Brennan and Buchanan 1985, p. 68). It is too late to turn back the clock, bygones are forever bygone – and we start from here.

Buchanan is an economist. Yet he is also a conservative, a moralist, a believer in cultural consensus, a champion of institutional precommitment. Arguing consistently that an 'unthinking conservative stance' (Buchanan, 1986:56) is no substitute for flexible adaptation and responsive reform, Buchanan is insistent nonetheless that the rules must be 'quasi-permanent', 'relatively absolute absolutes', if individuals are to be in a position to plan their private futures and the nation is to experience a viable degree of stability: 'It is rational to *have a constitution*.' (Buchanan and Tullock 1962, p.:81). It is rational to build on the past in order to make a success of the future. Rational or not, it's the only game in town: 'We start from here *because* we start from there.' (Reisman 1999, p. 1). There is no other way.

Buchanan is a microeconomic reductionist. He is also an advocate of custom and convention. The mix of time-that-was with history-to-come is a distinctive compromise between the *ab initio* trade-offs of textbook economics and the respectful replication of an unthinking collectivism that brooks no challenge: 'What makes Buchanan's position unusual is the presence of his libertarian individualism alongside his cultural conservatism.' (Reisman 1990, p. 123). The subject of this paper is the accommodation between obedience and innovation, duty and liberty, which is so important a characteristic of Buchanan's window on the world.

Both the commercial contract and the constitutional contract presuppose a notion of inter-temporal obligation: 'Just conduct is conduct in accord with

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promises given.' (Brennan and Buchanan 1985, p. 100). If buyers and sellers made it their practice to default, if bad Samaritans became free riders in the expectation that good Samaritans would play by the rules, the social order would degenerate into the Hobbesian *bellum* and further gain-seeking would be difficult if not impossible. Learned attitudes, fortunately, impose a multi-period constraint: 'Ingrained in Western tradition is a sense of respect for the rights of others, including property rights.' (Buchanan and Devletoglou 1970, p. 122). Markets will fail in the absence of a 'common set of moral precepts', in the absence of 'respect for individual rights, once these are defined in law and/or customary standards of behavior' (Buchanan 1979, 212). The inherited mindset, on the other hand, 'provides the basic framework for our culture, our economy, and our polity – a framework within which the "free society" in the classically liberal ideal perhaps came closest to realization' (Buchanan 1988, p. 108). Markets will fail in the absence of handed-down social capital. Where yesterday's social contract marches in step with today's devolved decision-making, the market economy stands a better chance.

The lawbreaker in the sense of Becker makes his home in the present and seeks his utility in the future. Weighing expected benefit against the probability of punishment, his calculus owes something to extrapolated risks but nothing to remembered norms. The lawbreaker in the sense of Buchanan has a clearer recollection of an agreement already concluded. Living in the present, he knows that he made the implicit exchange of some freedom for some security when, at some time in the past, he accepted that mutual protection had to be put above short-term gain. He had given his word to live by the rules. His memory of his past-dated promise makes it impossible for him to proceed, Becker-like, in piecemeal pursuit of the better buy. His word is his bond. The past marches on.

A multi-period settlement is evidently a time-bound compact. *Ex ante* people agree to the restraints because they expect that the rules will leave them better off in their own estimation. *Ex post* people discover what the unknowable future really means for their felt well-being. We as a nation agree behind a veil of uncertainty to institute a regime of low proportional taxation – but Jack, years later, becomes incurably dependent on the welfare State. We as a community decide unanimously to contain health spending by concentrating care on young productives – but Jill, moving into the future, learns that she requires a transplant. The regret experienced by Jack and Jill cannot be ignored. In contrast to the repressiveness of Leviathan, however, at least it is the consequence of their own free compacting. The constitution



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once in place, it was their personal and private wish that they should thereafter start from *here* – but from *there* as well.

Yet tastes and preferences change; and no undertaking can deliver an invariant utility-level forever. Slopes and intercepts mutate. Indifference curves shift up and down. Most economists treat the re-contracting as timeless and costless. Buchanan is realistic enough to see it as a hurdle. Just as external costs are incurred where a past-dated compact is subsequently perceived to be sub-optimal, so transactions costs must be borne when a society makes up its mind to tear up one constitution and to move on to another. Discussions must be held, balloting conducted, side-payments negotiated lest existing rights-holders feel mugged by the majority. The process takes time. It involves a cost. Writing as an economist, Buchanan concludes that the cost-effective choice will often be to renounce altogether the pursuit of the more satisfying endstate that burns up more resources than it is worth.

Constitutional conservatism cuts down on waste. Due to the Wicksellian test, however, there is also a utility slippage. Jack and Jill, precisely because re-contracting costs too much, are made subject to rules that were settled on before they were born. Jack and Jill are made subject to an inter-generational compact, to a true Burkean commitment that the consistent Buchananite would find deeply disturbing if it were called the budget deficit. Inertia has a pay-off and the *status quo* a rate of return. Well and good; but still the present day might not have a chance to record an opinion for the simple reason that democracy is not a utopia in which free gifts come without price-tags attached.

Doing nothing cuts down on cost. Doing something means both transactions costs and the diseconomies of pragmatism. On the one hand there are the politicians, calculatively expanding budgets in order to placate marginal constituencies, cynically tinkering with taxes in order to purchase voters' support: 'Nothing could do more towards promoting nonconstitutional attitudes than continued readjustment of basic income tax rates. Such readjustment surely furthers the view that the political process, as it operates, is after all little more than a complex profit-and-loss system.' (Buchanan 1977, p. 252). On the other hand there are the citizens, hungry to use in-period negotiation as an opportunity to re-think behind-the-veil miscalculations, all-too-aware that long implementation-lags and the prohibition of discretionary management would deliver equity but deprive current cohorts of an imminent return: 'Reasoned, and reasonable, discussion should be possible on the most efficient structure of asset-transfer taxation that would come into effect in,

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say, a quarter or a half-century after decision. Individuals who participate in the discussion on this basis will be unable to identify their own positions so clearly.' (Buchanan 1967, p. 299). Politicians promote *anomie* through their example of corruption, manipulation and Keynesian buying on credit. Citizens threaten fairness through rushed re-contracting before the passage of Shackle-like time has had the chance to lower Rawls-like the veil. It is the great attraction of constitutional conservatism that it stands as a bulwark against worst-possible outcomes made especially likely by social actors such as these.

Anxiety, fear and minimax are clearly core elements in Buchanan's conservatism. A speedy response could mean the successful resolution of what might otherwise have become a major problem. It could also mean that a minor problem is magnified into a disaster. An optimist in respect of intervention might be prepared to take a chance on the day-by-day option. Buchanan, however, is a pessimist, and by nature risk-averse: 'Hamlet said that it is better to bear those ills we have than to fly to others we know not of, but his statement applies also to benefits or pleasures.' (Buchanan 1967, p. 71). Tastes and preferences change but the risks of reacting do not. There is in the circumstances much to be said for a tried-and-tested rule that has shown what it can do.

The past lives on in the present. One consequence is that existing titles to property must be treated as *prima facie* just. Buchanan would not extend his tolerant acceptance of current endowments to possessions seized in breach of the social compact: the street thief enjoys no reasonable entitlement to his haul. Moving backwards into history, however, Buchanan sees little point in re-opening the legitimacy of long-established expectations.

Present-day fortunes can be traced back to the Old South slave-trade, tax-funded pensions to the Downsian vote-motive, protective tariffs to Olson-like redistributive coalitions. Society should take great care not to repeat the errors of the past. It should certainly not pretend to itself that the mistakes were progress, that whatever *is* is good: 'I have no faith in the efficacy of social evolutionary process. The institutions that survive and prosper need not be those that maximize man's potential.' (Buchanan 1975, p. 167). What society cannot do is to alter the rules retrospectively in such a way as to confiscate the claims that existing asset-holders acquired as a consequence of social conventions once in force. We start from here: 'I do not especially like the status quo defense that my methodology forces me into, but where can I go? ... The point I always emphasize is that we start from here and not from

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somewhere else.' (Buchanan and Samuels 1975, p. 19, 27). Indeed we do; and so did the asset-holders. We start from *here*. They started from *there*. Their *there* has become our *here*. That's the way it is.

As with matter, so with mind. Socialised attitudes are the institutional inheritance that gives unity to the present-day's strivings. Most visibly so in a traditional, tribal society, Buchanan believes that the handed-on mindset is also the constitutional prerequisite for self-perceived success in the case of market capitalism, history's most dynamic-and decentralised-economic system.

Market capitalism presupposes that parents will have taught their children how to play the game. The valuational capital will extend to purposive search for utility and profit, rational choice as the selective standard, the Protestant work-ethic supported by deferred gratification, the acceptance of individual responsibility, the commitment to lawful contract. It will also incorporate an understanding of sequence and life-plan, the putting in place of the basics and the foundations upon which stepwise incrementalism (the marginalism, say, of a heart surgeon applying for a more senior post) will subsequently have to build: 'A person who has not trained for long-distance running cannot compete in the Boston marathon regardless of a strong desire to do so.' (Brennan and Buchanan 1985, p. 71). The valuational capital, favourable as it will be to the entrepreneurial initiative of the ambitious go-getter, will assign a high importance to long decision-making horizons.

It will look with the deepest suspicion upon the permissive short-termism of "'Enjoy, enjoy" – the imperative of our time' (Buchanan and Wagner 1977, p. 65). In that sense the constitutionalism appropriate to dynamic capitalism is also the conservatism that characterises the essence of the constitutional perspective itself.

Both the capitalism and the constitutionalism would be put at risk by moral anarchists such as welfare scroungers and student activists. The revolt against the rules, short-sighted and self-defeating, is in truth a revolt against the living standards and the liberties for which the multi-period constraint is the *sine qua non*. Buchanan is strongly in favour of a society in which citizens adhere behaviourally 'to the precepts of a moral order' (Buchanan 1986, p. 116), in which young people are prepared to carry on 'the ways of conduct known to be "decent" by their elders' (Buchanan and Devletoglou 1970, p. 103). The moral order is not an in-period consumable. The elders pass on the conventional wisdom. Buchanan is an economist. Fundamentally, he is a conservative as well.

## DAVID REISMAN

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## 10 Buchanan and Wiseman

ALAN HAMLIN<sup>1</sup>

- I. Some Background
- II. Virtual Co-Authorship

While visiting the Center for Study of Public Choice in April 1994 I was allowed to attend, as an observer, sessions of a seminar constructed as a meeting of co-authors of James Buchanan. At the end of one session, Jim was asked to reflect on the role of co-authorship. In responding, Jim identified a number of patterns of co-authorship - ranging from long-running collaboration to a one-off paper in one dimension; and from genuine joint-production in which each author contributes to and learns from the partnership, to a more asymmetric senior/junior structure in another dimension. In an essay that is intended for distribution primarily from a web site, it seems appropriate to identify a further form of co-authorship, and label it 'virtual co-authorship'.

'Virtual co-authors' are individuals who collaborate and engage in almost all of the elements of joint production, but do not actually write or publish together. I identify Jim Buchanan and Jack Wiseman as a case of long-term 'virtual co-authors'. The authorial conjunction 'Buchanan and Wiseman' appears in no real bibliography (which, in part, explains why I have chosen it as my title) and this might seem surprising given their friendship over more than thirty years and the similarity of their interests and vision. My motivation in writing this brief piece is to explore this particular instance of virtual co-authorship a little and, by so doing, to pay my respects to both Jim Buchanan and Jack Wiseman on the occasion of Jim's 80th birthday - particularly since 1999 would also have seen Jack's 80th birthday.

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## I. Some Background

Buchanan and Wiseman first met at the LSE in 1960.<sup>2</sup> By that time each had already established the broad themes of his academic concerns. On Buchanan's side most of the work - with Gordon Tullock - on *The Calculus of Consent* (1962) was already complete; and the same is true on Wiseman's side for the work - with Alan Peacock - on *The Growth of Public Expenditure in the United Kingdom* (1961). Jack Wiseman was already familiar with much of Jim Buchanan's earlier work - particularly *Public Principles of Public Debt* (1958). Their common interests ranged across almost the whole of public finance, economic policy, and economic method - and so it was not surprising that they discussed these interests together. But the list of their common interests was not, in itself, the source of their mutual recognition as potential collaborators. The real key lies in the similarity of their visions. Each had, in their earlier work, and from quite separate influences<sup>3</sup>, adopted a perspective that questioned the then mainstream approach to questions of economic policy. The precise details of their positions and the scope of their vision differed, but the fundamental emphasis on individual choice and exchange; on the proper interpretation of the idea of opportunity cost; on the role of uncertainty; and on the logical and practical defects of any system of collective planning, were clear enough. Jack Wiseman placed special emphasis on uncertainty as unknowability - itself a variation on the theme of Frank Knight, and therefore easily recognised and understood by Jim Buchanan - and on the subjective nature of all real decision making. Jim Buchanan's emphasis was by that time already on the role of unanimity in collective decision making and as a normative benchmark, and on the idea of political and institutional failure - the foundational shift from public finance to the public choice approach.

The bond created by their common substantive interests, together with their shared perspective was further strengthened by the simple but important fact that they liked each other. Although some of their non-academic interests were specific to their cultures - Jack's interest in cricket made as little sense to Jim as did Jim's liking for baseball to Jack - they clearly enjoyed the fact

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2 More detailed biographical information is available in BUCHANAN (1991, 1992), WISEMAN (1989).

3 In Buchanan's case, most obviously, Knight and Wicksell; in Wiseman's case, Coase and Robbins.

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that their plain-speaking (to put it mildly), no-nonsense approach marked them out in the academic world of the early 1960s. To put the matter briefly, they took their intellectual interests seriously, but did not take academic manners too seriously. The stage was set for a long professional and personal relationship. Over the next thirty years, until Jack Wiseman's death in January 1991, they met frequently. Jack was a regular visitor to the Center for Study of Public Choice, and they would also meet during Jim's many visits to Europe - perhaps in the context of the Institute of Economic Affairs, or the International Institute of Public Finance.

All of the above I understand from my own conversations with Jack and with Jim, and from their autobiographical writings. But I would like to add something from more direct, personal observation. I first met Jack Wiseman when I went to the University of York as a beginning graduate student in October 1973. After a year he became my thesis supervisor, and I worked within his Institute for Social and Economic Research for two more years before moving on to a lectureship. I knew some of Jim Buchanan's work when I arrived in York, but had no real understanding of the Buchanan enterprise as a whole. It was through Jack that I - and a number of others - were introduced to Jim both intellectually and personally. In a sense, Wiseman was the lens through which I saw Buchanan's work. I now understand that the lens distorted some aspects while clarifying others (it was certainly rose-tinted with friendship) but without the lens, I might never have developed independent vision.

In the middle years of his career, Jack was professionally concerned with a variety of more applied topics, not unconnected to the need to finance his Institute. He wrote little that was aimed at developing his general approach, or connecting it to the then burgeoning Buchanan project. Despite (or, perhaps, because of) this lack of relevant written output, he would talk. And anyone who ever met Jack will agree that he could, in his own phrase, 'talk the hind leg off a donkey'. And his talking would always revert to his basic perspective, its implications and its relationship to the ideas of public choice theory. By this means he established a sort of personal oral tradition that influenced many who passed through York - whether in his Institute, the Department of Economics or the Department of Politics; and whether as students or as faculty members. At that time, Jack Wiseman and his group at York were probably the only significant group in the UK to recognise the significance of the public choice approach, and foster an interest in that approach. In this way Jack was much more influential as an advocate and sup-

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porter of public choice theory than one could guess from the purely written record - and certainly more important than is commonly realised in the still predominantly American circles of public choice theory itself. Among the then-young people who were at York in the short time that I was there one might list Bob Sugden, Albert Weale and David Austen-Smith and this listing could be expanded greatly by moving through the years. Another measure of Jack's influence over the development of a specifically British constituency for public choice theory can be found by reading the British text *Public Finance and Public Choice* by John Cullis and Philip Jones (John Cullis was himself at York rather later than me) which cites Jack Wiseman repeatedly and in a wide variety of contexts: compare this with any American text.

Once I had moved beyond my DPhil and had the possibility of taking some sabbatical leave, Jack suggested that I might spend it at Center for Study of Public Choice - still at that time located at VPI in Blacksburg - and so I finally met Jim Buchanan for the first time in any meaningful way in 1982. In many ways, the contrasts between Jim and Jack were more immediately obvious to me than the similarities - since I already expected and to at least some extent understood the nature of their intellectual similarity. To someone used to Jack, Jim initially seemed rather too quiet. I attended several seminars, on topics directly related to Jim's work, at which he spoke little and then only in response to more or less direct questions. However, over the next few days - in quiet conversations in the hall, or by exchange of notes - he would make relevant comments and points until all outstanding issues were resolved to his satisfaction. The mode of expression was certainly different, but the underlying commitment to argument was the same. But the most obvious contrast was in the scale and academic dedication of the Center. A major lesson that I learnt on that first visit was the value of a particular sort of intellectual integrity - of pursuing your own research agenda without too much regard for fashion or received wisdom or other considerations. Of course, by this time it was already abundantly clear that the Buchanan project was a major success in the sense that its value was being recognised within the mainstream of economics and politics - the Nobel Prize was only a few years in the future - but the lesson is valuable independent of that.

Over my career to date, almost everything that I have written - either alone or with real co-authors (most obviously over the last decade with Geoffrey Brennan) - has been deeply influenced by the work and the vision of Jim Buchanan and, to a lesser but still personally significant extent, Jack Wiseman. Perhaps my particular personal history leads me to overstate the signifi-



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cance of the relationship between these two - and I would certainly not deny that for each of them there were many other significant collaborations that helped to shape ideas. My claim is only that the Buchanan-Wiseman link *was* significant, and that most of those other collaborations left their mark in the record by way of joint publications - so that there is a danger that any narrow reading of the record might overlook the Buchanan-Wiseman connection.

### II. Virtual Co-Authorship

So, what might Buchanan and Wiseman have written together? Based on what they wrote separately and on what I know of their interests and character, how might their collaboration have gone if it had moved from the status of 'virtual co-authors' to real co-authors? We will never know. There are many topics that they might have addressed together, but I will speculate briefly in just one of the many areas they might have considered at a relatively early stage: the economics of clubs.

The clues here are relatively easy to see. One of Jack's early papers - Wiseman (1957) - made use of the idea of a 'club' as a part of an analysis of public utility pricing. The idea here was that the consumers of a public utility provided under a multi-part tariff could be seen as forming a type of 'club', and that this fact, together with the presumption that such 'clubs' were voluntary, provided the basis for much of the normative appeal of the multi-part pricing solution to the public utility pricing problem. Somewhat typically, Jack's discussion is a strong criticism of the 'club principle' and, in particular, its normative appeal. And this is so even though he could not cite any reference providing any formal analysis of the 'club principle'. In a sense, Buchanan provided the missing reference with his famous (1965) paper *An Economic Theory of Clubs* - a paper that lays out a model of clubs within the mainstream neo-classical tradition in an attempt to fill some of the middle ground between the polar cases of private and Samuelsonian public goods. Wiseman's basic normative criticism of the 'club principal' was that clubs of this type operate to impose essentially arbitrary value judgements, since membership of the club is not truly voluntary, and the internal operation of the club is not truly based on either individual exchange or unanimity. As Jack once said to me, 'a club is usually a blunt instrument of coercion'. Of course, Jack's particular criticism is specific to the public utility pricing con-

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text, but Jack's clear interest in the normative aspect of the club principle and its application in different contexts, on the basis of a normative approach shared by Jim, together with the clearly specified and developed model in Jim's paper, could have provided the basis for a joint project on the theme of coercive and voluntary clubs - their emergence, their behaviour, and their role in specific institutional settings. Of course, much of this work was eventually done - but it did not appear under the names of Buchanan and Wiseman, and perhaps I might be allowed to think that it might have advanced the shift to the constitutional political economy approach had it been a Buchanan-Wiseman project.

A final question is *why* Buchanan and Wiseman did not, in fact, write together. Again, we will never know, but here I will offer three possible reasons beginning with the most prosaic. It may be that they were prevented from real co-authorship by simple practicalities. Particularly in the days before word processing and E-mail, co-authorship more or less demanded face-to-face contact on a regular and frequent basis, and a commitment to make time. By the early to mid 1960s both Jim Buchanan and Jack Wiseman were busy men with existing co-authors, on-going research projects, numerous academic and other commitments. Perhaps there were just too many practical obstacles. This is all true to at least some extent, but it is not very interesting.

A more interesting possibility focuses primarily on Jack Wiseman. Jack was constitutionally incapable of writing anything that was not true to his own methodological position. This did not place too tight a constraint on him as long as he stuck to more applied work, or to pieces that were essentially critical in nature. But once it came to attempts to express his own vision in any detail, or to build on his proclaimed foundations, the constraints imposed by his own subjectivism started to bind very quickly. Jack's situation was captured neatly by his one-time colleague, Alan Coddington, who was actually writing about Keynes, Shackle and Loasby, but could easily have been writing about Jack, when he wrote:<sup>4</sup>

"A consistent or all-embracing subjectivism is, analytically, a very self-denying thing. If subjectivist logic is followed .... there is nothing for economists to do but to understand certain (praxiological) concepts .... there would be nothing left but for the whole profession to shut up shop .... We would then be faced with a situation akin to one in which there was an out-

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4 I need hardly add that it was Jack who first brought this quote to my attention.

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break of Christian Science among the medical profession, or a passion for telekenesis among airline pilots." (Coddington, 1982, p486).

There is, no doubt, at least some truth in this suggestion that Jack's radical subjectivism could not sit easily with any constructive analysis. But there is a third and happier possibility. Perhaps Buchanan and Wiseman recognised that their state of virtual co-authorship offered both of them benefits of a kind, and of a quality, that might be threatened if they had seriously attempted to write together. The additional pressures and tensions generated by real co-authorship might have eroded the strong link that allowed them to provide each other with encouragement, friendly criticism and support for thirty years. The affection and respect that Jack had for Jim, and the strength Jack drew from their friendship were clear to anyone who knew Jack. That these feelings were mutual is indicated by the fact that it is Jack's portrait that hangs in pride of place just outside Jim's office door in Buchanan House. Perhaps real co-authors are more easily found.

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# 11 Notes on Buchanan on Methodological Individualism

GEOFFREY BRENNAN

- I. Introduction
- II. Individualism and Isolation
- III. Formation of Values
- IV. Individuation and Interests
- V. Methodological vs. Normative Individualism

"(1) For constitutional economics, the foundational position is summarized in *methodological individualism*. (2) Unless those who would be participants in the scientific dialogue are willing to locate the exercise in the choice calculus of individuals, *qua* individuals, there can be no departure from the starting gate. (3) The autonomous individual is a *sine qua non* for any initiation of serious inquiry in the research program. (4) Individual autonomy, as a defining quality, does not, however, imply that the individual chooses and acts as if he or she exists in isolation from and apart from the community or communities of other persons with whom he or she may be variously associated. (5) Any form of community or association of individuals may reflect some sharing of values, and, further, any individual's formation of values may be influenced by the values of those with whom he or she is variously associated in communities. (6) The communitarian challenge to methodological individualism must go beyond the claim that individuals influence one another reciprocally through presence in communities. (7) The challenge must make the stronger claim that individuation, the separation of the individual from community is not conceptually possible, that it becomes meaningless to think of potential divergence between and among individual interests in a community. (8) Stated in this way, it is evident that methodological

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individualism, as a presupposition of inquiry, characterizes almost all research programs in economics and political science; constitutional economics does not depart from its more inclusive disciplinary bases in this respect.

The communitarian critique does not often appear in such blatant guise. For constitutional economics, in particular, the critique apparently leaves the individualistic postulates unchallenged, while either implicitly or explicitly asserting the existence of some supra-individualistic source of evaluation. Individual evaluations are superseded by those emergent from God, natural law, right reason, or the state. This more subtle stance rejects methodological individualism, not on the claim that individuation is impossible, or that individual evaluations may not differ within a community, but rather on the claim that it is normatively improper to derive collective action from individual evaluations. To the communitarian who posits the existence of some supra-individualistic value scale, the whole analysis that builds on a base of an individualistic calculus can only be useful as an input in schemes of control and manipulation designed to align individualised preferences with those orderings dictated by the overarching norms for the community."

JAMES BUCHANAN: "The Domain of Constitutional Economics", *Constitutional Political Economy*, Vol. I, No.1 (1990), pp. 13-14.

### I. Introduction

In this extended quotation, Buchanan sets out the central elements of one of the hard-core features of 'constitutional economics', as he would identify that enterprise. The element in question is, of course, methodological individualism. My object in this brief paper is to elaborate and, I hope, clarify Buchanan's observations. I do so because, like him, I see methodological individualism as a core attribute of the economic way of thinking. And further, because it is an attribute that is often misunderstood or misinterpreted –

## NOTES ON BUCHANAN ON METHODOLOGICAL INDIVIDUALISM

both by critics and (occasionally) practitioners of the 'economic approach'. It is notable, for example, that while methodological individualism is regarded as *de rigueur* in economics and in constitutional economics specifically [so much so indeed, that without it, as Buchanan states in the second sentence of the epigraph "*there can be no departure from the starting gate*"] methodological individualism is equally regarded as total anathema in sociology and much sociologically informed political theory. Without wanting to diminish the significance of the differences in approach that these two broad traditions of analysis exhibit, it seems to me unlikely that disagreements over the propriety of methodological individualism are solely attributable to such differences: terminological confusion seems likely to play an important role. In other words, there may be rather less here in the way of genuine disagreement - and rather more of talking at cross-purposes. For that reason, some attempt at clarification seems called for. Here, I shall use the Buchanan quotation as a framework for this attempt.

In doing so, I recognize that the particular statement contained in the epigraph is by no means the only one Buchanan has offered on the question of methodological individualism and that the quibbles that I have about aspects of this particular statement may be regarded as slightly 'unfair' to Buchanan. My defence is two-fold: first that the statement provided purports to be a synthetic account of what methodological individualism entails, and is therefore brief and to the point; and second, that my interest here is not to *evaluate* Buchanan's account so much as to *elaborate* it. There can, I think, be little doubt that, on this topic at least, my views and Buchanan's are very much in sympathy.

### II. Individualism and Isolation

*"Individual autonomy....does not imply that the individual chooses and acts as if... in isolation from....communities of other persons."* (Epigraph, sentence 4)

Critics of methodological individualism are often inclined to point to the economic approach as radically *asocial*. It therefore needs to be stated categorically that economics is a method of *social* analysis: the various applications of the economic method to the study of political processes and institutions are ineluctably 'social'. Sometimes it may seem otherwise. The exposi-

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tion of *rationality* that economics offers, for example, is often conducted as if it dealt with Crusoe on his island (totally in isolation from Friday). The exposition in question focuses specifically on Crusoe's calculus in deciding among his various possible activities (swimming to the shipwreck; fishing; coconut gathering; constructing tools and so on). And an elaborate account of this calculus may occupy a significant chunk (as Buchanan is inclined to argue, an *excessive* chunk) of the standard introductory 'economic principles' course. But, properly conceived, this account of rationality is only a piece of the specifically *social* analysis that is to follow - social analysis that is concerned with the many such "Crusoes" all *interacting* within the context of market institutions, and constructing thereby the network of interpersonal relations - of specialisation, exchange and mutual accommodation - that constitute the economic order. Perhaps it takes the typical economics-principles course too long to get to the point. Perhaps that course should begin with Reid's essay on the pencil, or Richard Scarry's children's book '*What Do People Do All Day?*' or better still, the first few chapters of '*The Wealth of Nations*'. Maybe the ideal course would begin with 'exchange' - and we should go on to elaborate the theory of demand and supply as elements of an analytically more sophisticated version of the exchange story. Perhaps some students might mistakenly come to think of the economy as a kind of Crusoe writ large - with the central problem being one of 'allocating' the 'economy's resources' to various activities, just as Crusoe does.

Doing so would certainly make it more likely that more students will "get the point". That is, they will come to see that social *interdependence* is the very essence of the picture of social phenomena (including the economy) that economics offers. Within that picture, all that "individual autonomy" is taken to mean is the idea that each individual controls her own actions - so that the actions of any individual agent, A, are not controlled by the intentions of some other entity's (B's) state of mind - whether B is some other individual, some group or some exogenous social force). The set of autonomous individuals, so understood, *interact* in social relations (including narrowly economic ones) in such a way that the actions of each are influenced by the actions of all others. Precisely how they interact, the nature of their mutual influence, is the essential subject-matter of economics - or, at the very least, is an essential *element* in that subject-matter. None of the "autonomous" agents in any interesting economic setting is entirely independent of the actions of others.



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It is useful here to distinguish between two possible mechanisms of interdependence - one form that operates broadly via the medium of prices; the other that operates via direct psychological influence. The former is the interdependence that is exemplified in the complex interactions of the market-place; the latter we might think of as arising via mechanisms like direct persuasion/argument, peer pressure and the like, which have traditionally been the province of the social psychologist. A neat way to distinguish the two forms of social interaction is by reference to a distinction, familiar in the economist's lexicon, between behaviour/action on the one hand and preference/motivation on the other. It is of the essence that, in the kind of interaction familiar to economists, agents can alter their actions without any change in preferences. That kind of action-adjustment is characteristic of price-response, and is the central feature of market exchange. I say to you: I shall do X if you do Y; and if the contract is agreed and the performance requirements are satisfied, I *do* do X, and you *do* do Y, without any change in the preferences of either party. To say this, is merely to rehearse a familiar Buchanan theme. And it is a further Buchanan theme that the range of such mutually satisfactory behavioural adjustments extends much more broadly than the formal market-place. Within many well-functioning marriages, for example, exchanges (typically implicit) of a similar kind go on: reciprocation is the oil of many social relationships which, in the absence of such lubrication, would cease to function. Hence, the exchange-based 'sociology' of George Homans and Jim Coleman - to say nothing of the 'public choice' political theory of constitutional economics.

I have laboured the point here to some extent because the way in which Buchanan juxtaposes the fourth and fifth sentences of the epigraph might be seen to suggest that "*isolation from the community*" is to be understood solely by reference to the absence of *motivational* influences. Whatever Buchanan exactly had in mind when writing, it would be more faithful to the Buchanan intellectual scheme as I understand it, to insert a word like "Moreover" at the beginning of the fifth sentence to indicate that these sentences refer to separate thoughts - that the fifth sentence is not a mere restatement and elaboration of the fourth, but a quite different point.

### III. Formation of Values

*"...any individual's formation of values may be influenced by the values of those with whom he or she is variously associated in communities"* (sentence 5)

The strategy of Buchanan's argument in the fifth, sixth and seventh sentences seems to be that of claiming the middle ground. We might, that is, allow for a spectrum of possibilities running from that case where the individual agent's 'values' are totally determined by the community, to the case where the agent's values are wholly independent of community influence. Buchanan's simple point is that methodological individualism remains relevant to all except the former extreme case. I have no objection to that claim as far as it goes; but it does seem to me that Buchanan concedes too much here. And this in three senses.

One of these senses relates to the role of 'values' as such in social explanation, and of the possible divergence between values and motivations. The second relates to the method to be used in the explanation of the processes by which community influence is exercised. The third relates to the question of whether "*individuation*" is appropriately to be understood as a matter of separable "*interests*" as Buchanan puts it, or in some other terms (as I shall argue below).

Let me briefly deal with the first two senses. First, even if values as such were totally determined by direct psychological forces, so that all individual agents within a given community held identical values, this would constitute a problem for methodological individualism only if values as such fully determined behaviour. But values, even where sincerely held, are typically only one force in the typical agent's motivational array. "Interests" more narrowly conceived are another. Consider a simple example. Suppose there exists a highly trained military unit - a brigade - which is under attack from enemy forces. Suppose further that each individual member of this unit has been carefully acculturated in the values of loyalty to the group - the "all for one, and one for all" spirit of Dumas' musketeers is the animating element of the brigade's identity. And further, when under attack, it is in the interest of each that all fight as vigorously as they can. Yet there remains an impulse - entirely rational at the individual level - to turn and flee. The best chance of survival for each will be to exit the field of battle quietly, leaving his comrades to carry on fighting (thereby protecting his retreat). And this will be

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true for all of them, whatever the others do. In other words, each member of the brigade is locked in a prisoner's dilemma with all his comrades. Unless this fact is understood, unless the (entirely individually rational) impulse to cut and run is acknowledged, we can have no proper understanding of what it is that the careful acculturation of loyalty among group members is designed to overcome, or of what it is that distinguishes battle-seasoned troops from new recruits, or of what institutional arrangements might be put in place to support the individual soldier in acting in accord with the values of loyalty that he, quite sincerely, affirms. It is one thing for me to believe firmly that X is what I should do, and another thing to actually do it. The conclusions I draw from this example are two-fold: first, that collective values are not always totally binding behaviourally; and second, that even in cases where they are, one cannot understand the work that these collective values are doing without a more individualist analysis.

[It is worth noting the obvious point that although allowing for community influence on values seems unexceptionable - indeed, the contrary is deeply implausible (the idea of each person "inventing" her values for herself out of whole cloth rather strains credulity) - "community" itself is an ill-defined concept. Whereas the individual is terminologically singular, the "communities" to which she belongs are multiple: family; profession; club(s); political party; nation - and even within each of these communities there are closer and more distant ties, stronger and weaker influences. Even if we thought that community was somehow the logically primary concept, and each "individual" was properly to be conceptualised derivatively as the intersection of the communities to which she belongs, we would still be led back to the analytic necessity of individuation in any account of social behaviour]

The second issue that seems important to raise here is that of explaining the pattern of psychological influences that are under consideration. Suppose such psychological influences exist. Suppose indeed that they are of such potency in some case that members of the group in question *do* have absolutely identical values and that these values are behaviourally compelling. Then to be sure, in giving an account of the group's behavioural response to some external shock, it would be perfectly acceptable to treat the group as a unit of analysis - as a rationally 'choosing' entity. To insist that we have recourse to the individual agents who make up that group would seem pedantic, not to say pointless. But there surely remains an issue as to how the patterns of influence that "all" exercise on "each" come into being. What is it that makes A subject to B's influence - or both A and B individually subject to

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their joint influence? This question may not make much sense to a methodological collectivist - but if so, that seems to be a weakness in the collectivist approach. Why does A join group Z rather than group W? Why, when as in the family case membership is quasi-involuntary, does family F exercise a more decisive influence over its members than family G does? Conceivably the account to be given of these aspects will lie a long way from rational choice theory. The account may instead focus on certain psychological propensities or early childhood experiences or whatever. But the account will nevertheless be - must be - individualist in its method, because recourse is being made in explanation to the individual mind. And, in fact, the resources of rational choice theory should not be dispensed with too quickly here. Suppose, for example, that an important reason why agent A adheres to the norms of group N is because A desires the esteem of members of that group (or seeks to avoid their dis-esteem). Here, A may "internalise" the values of group N and act more or less identically with group-N members. The underlying explanatory model, however, is entirely within the economist's framework. We could derive a 'rational actor' account of the desire and pursuit of esteem- of the demand for and supply of esteem - which would perhaps not be too unlike elements of Adam Smith's *Theory of Moral Sentiments*. [I have attempted such an account in collaboration with Philip Pettit in *The Hidden Economy of Esteem* (*Economics & Philosophy* forthcoming)]

The general thrust of this section has been to defend a role for methodological individualism even in what might be thought of as the most inhospitable circumstances. The claim is that even where individual values are totally 'communally constructed' there may still remain a role for methodological individualism - though perhaps, as the Buchanan quotation implies, a somewhat diminished role compared with that in the conventional economic model.

### IV. Individuation and Interests

*"The challenge must make the stronger claim that individuation....is not conceptually possible, that it becomes meaningless to think of potential divergence among and between individual interests in a community."*

How is 'individuation' to be understood in the context of discussions about methodological individualism? In the sentence quoted here, Buchanan

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implies that the crucial issue is what we might term independence of interests - that if it were impossible to draw a conceptual distinction between the interests (or more generally, the motivations) of A and the interests of other members of the relevant group to which A belongs, then methodological individualism would be confounded. I seek to dispute that proposition. I want to argue that independence of *action* is the more important feature. I seek to justify this claim by appeal to a simple example.

Consider the co-ordination problem depicted in Fig. 1. In this example, individual interests are totally aligned: the evaluations of the cells in the matrix are identical for the two players (who are designated as A and B). Indeed, we can think of the relevant outcomes in the cells to be the provision of some Samuelsonian public good to the A/B group, with the additional stipulation that A's and B's evaluations of the public good are identical. Or, if the mere counter-factual possibility that A's and B's evaluations might in principle differ is seen as an excessive concession to "the conceptual possibility....of individuation", we can simply denote the relevant pay-offs as a single number, presumed to motivate A and B and derived (let us suppose) from some Hegelian collective mind. Indeed, we can dispense with pay-offs entirely and simply depict the joint rankings of the various outcomes, as in Fig.2. Nevertheless, provided that the collective mind postulated serves only to evaluate the outcomes and not to jointly *cause* A's and B's *actions* (conceived as strategy choices), then a critical element of individuation remains. That is, if A and B are independent loci of action, so that A determines the choice between  $a_1$  and  $a_2$  and B that between  $b_1$  and  $b_2$ , then both A and B must individually reflect on what other is likely to do. Each will need to consider the other's likely reasoning and calculation activities [or whatever else it may be that leads the other to act in particular ways], even though it happens to be...."*meaningless to think of potential divergences.....between individual interests.*"

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		<b>B</b>	
		<b>b<sub>1</sub></b>	<b>b<sub>2</sub></b>
<b>A</b>	<b>a<sub>1</sub></b>	[10,10]	[0,0]
	<b>a<sub>2</sub></b>	[0,0]	[10,10]

Figure 1

		<b>B</b>	
		<b>b<sub>1</sub></b>	<b>b<sub>2</sub></b>
<b>A</b>	<b>a<sub>1</sub></b>	good	bad
	<b>a<sub>2</sub></b>	bad	good

Figure 2

Now, it may be thought that the predicament embodied in the simple co-ordination game in Figs.1 and 2 is trivially solved: all that is required is for one party to announce what she will do; then, the other has adequate reason to act as if that announcement *is* true and co-ordination will be achieved. But even in two-person games with only two strategies for each, co-ordination may be tricky. Consider, for example, the interaction depicted in Figures 3 and 4.

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		<b>B</b>	
		<b>b1</b>	<b>b2</b>
<b>A</b>	<b>a1</b>	[5,5]	[0,0]
	<b>a2</b>	[-20,-20]	[10,10]

Figure 3.

		<b>B</b>	
		<b>b1</b>	<b>b2</b>
<b>A</b>	$a_1$	better	bad
	$a_2$	worst	best

Figure 4.

Here again there is complete alignment of valuations of the possible outcomes. But here A knows that B must trust that A will choose  $a_2$  in order to secure the best outcome, ( $a_2 b_2$ ); but in choosing  $a_2$ , A risks the worst outcome ( $a_2 b_1$ ). So A may be tempted to choose  $a_1$  in which case B will have reason to choose  $b_1$ .

In short, there is nothing in the logic of the interaction that ensures the best outcome, and although communication among the players may help, each has some reason to be anxious about the reasoning and calculation of the other, even after the communication has occurred.

For example, suppose that for reasons of historical accident, A and B have happened to co-ordinate on the ( $a_1 b_1$ ) outcome. It seems clear that this outcome may prove extremely stable over iterations, despite the fact that a better outcome ( $a_2 b_2$ ) is on offer. If the 'common mind' chose actions for each, then the group would act 'rationally' in exactly the way a single individual is presumed to act. But if all the 'common mind' does is to determine evaluations, then outcomes like ( $a_1 b_1$ ) can emerge and prevail as stable equilibria. Without an analysis incorporating methodological individualism, no explanation of this ( $a_1 b_1$ ) possibility seems available.

The lesson I draw from these simple examples is that the property that is relevant for methodological individualism is individuation of *action* rather than individuation of interests or evaluations. If A's and B's actions are not jointly caused, we cannot relax the methodological individualism requirement. Of course, in some structures of interaction, common evaluation / interests / motivation will be sufficient to secure unique action. ( All those interactions which have a dominant strategy for both players under the common ranking scheme, for example). The point here is simply that common evaluation is not enough in all cases.

## V. Methodological vs. Normative Individualism

*"This more subtle stance rejects methodological individualism.....on the claim that it is normatively improper to derive collective action from individual evaluations...To the communitarian...., the whole analysis that builds on a base of an individualistic calculus can only be useful as an input in schemes of control and manipulation....."*

In the second paragraph, Buchanan seems to shift ground in a manner that I am not sure I understand. What seems to be at stake here is a distinction between methodological and normative individualism - a distinction which in itself is clear enough in principle perhaps, but which seems to me to be blurred by the discussion here. As I read it, this *"..more subtle .... communitarian critique"* does not - despite Buchanan's initial claim - reject methodological individualism at all. After all, as the last sentence implies, the communitarian will still have to employ an individualistic method in deriving relevant inputs into the normative enterprise of *"control and manipulation:"* There is no escape here from the use of appropriate explanatory method. So that, if the communitarian does indeed *"reject methodological individualism"* on grounds of normative impropriety, she seems both to be making a simple category error (failing to distinguish an "is" from an "ought") and moreover to be repudiating the rejection by her own practice. If this putative "rejection" does indeed rest on communitarian critique of methodological individualism, the critique is not so much *"more subtle"* as confused. Buchanan is, as is manifestly clear from other writings, himself a normative individualist - and much of his social analysis represents an elaboration and defence of the social institutions that emerge from that normative foundation. Much of what Buchanan argues for in that context I myself find extremely persuasive. But in the context of *methodological* individualism, normative commitments seem to me to be a side-issue. Or at least, we need to distinguish sharply between those normative considerations that specify how we think the world ought to be, and those more abstract norms that govern clear reasoning about, and best explanation of, the world as it is. It is in the latter connection that the case for methodological individualism is to be understood; and in my view, Buchanan's second sentence applies no less to the communitarian than to the normative individualist. That is, "unless....would-be participants in the scientific dialogues are willing to locate the exercise in the choice calculus of individuals qua individuals, there can be no departure from the starting gate."



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This requirement does not commit the "participant in scientific dialogue" to *normative* individualism – just to good social scientific practice. Of which *methodological* individualism, in Buchanan's view and my own, is a necessary piece.

## **Part III**

# **Constitutional Economics**

## 12 The Importance of Uncertainty in a Two-Stage Theory of Constitutions

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- I. The Constitutional Context
- II. The Case of Binary Choices
- III. The Constitutional Contract
  1. Optimal Collective Action with Only Identity Uncertainty
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- IV. Symmetric and Asymmetric Bans and Obligations
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- VI. Expanding the Number of Groups of Individuals
  1. Binary Choices
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- VII. Decisionmaking Costs
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- VIII. Rights and Obligations
- IX. Summary
- X. Concluding Arguments in Defense of the Theory

The idea that government is the ideal institution for providing certain types of goods and for constraining certain types of actions appears in the work of Adam Smith (1776), Wicksell (1896), Samuelson (1954) and many other economists and can be described as the main *normative* justification for government in the economics literature. In this "economic" view of the state, collective action is a positive sum game. The purpose of government is to achieve a Pareto optimal allocation of resources, and in the absence of transaction costs this could be achieved through voluntary and unanimous agreements among individuals. Governments are justified insofar as they economize on private contracting costs. Even with government the ideal decision

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rule is a unanimous agreement among all citizens with the use of some less than unanimity rule justified only to save transaction or decisionmaking costs (Wicksell 1896; Buchanan and Tullock 1962, pp. 63-91).

The economic view of government stands in stark contrast to what we might call the "political" view of government that sees collective action as a zero sum game, and government as an institution for resolving conflicts. Here it is the property rights or more general distributional issues that must be decided, and the ideal voting rule is often thought to be the simple majority rule (Riker 1962, p. 174; Barry 1965, p. 113; Rae 1969, 1975).

In practice governments must decide both types of issues, and thus the question of which procedure to use to decide each type of issue arises. This paper answers this question by breaking the political process into two stages.<sup>1</sup> In the first, the community unanimously agrees to the constitution. This constitution may allow certain actions, and ban or compel others. It may also define voting rules to be used in the second stage of collective decision making to allow, ban or compel actions. Citizens vote at each stage of the political process so as to maximize their expected utilities.

The analysis allows us to specify conditions under which certain bans and obligations might be included in a constitution, while others are decided by legislative action. The theory defines the "optimal voting rule" in some situations, and the conditions under which the majority rule is this optimal rule. We also illustrate why and how a "tyranny of the majority" can arise under a constitution that is unanimously agreed to by utility maximizing individuals. We shall see that under some conditions asymmetric treatment of individuals in the constitution may be optimal, in others symmetric treatment may be, if not the optimal way to mitigate the potential for the majority to tyrannize over minorities, at least the most feasible way.

No constitution has ever been written and unanimously accepted by the full membership of a community. Given this, our theory might be viewed as *a particular* normative theory of political institutions, one that assumes that the constitution *ought* to maximize the expected utilities of the individuals governed by it. The theory can also be viewed as positive, however, in the sense that it predicts the kinds of institutions that individuals *will* include in a constitution, if they seek to maximize their expected utilities under it. To the extent that the drafters of actual constitutions seek to increase the welfare (utilities) of future citizens when they write a constitution, the institutions

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<sup>1</sup> This methodology was first employed by BUCHANAN AND TULLOCK (1962).

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predicted by the theory developed here should be observed in practice.<sup>2</sup> We shall take up this positive/normative distinction again, briefly, in the conclusion.

The issues addressed are central to political theory, and have been much discussed in the literature. A central objective of the paper is to develop a uniformed framework for analyzing the choice of political institutions in a two-stage theory of constitutions as has been employed by Buchanan and Tullock (1962), Rae (1969) and others. We shall, therefore, confine our analysis to the class of political institutions upon which this literature has focussed - namely the family of qualified majority rules running from the simple majority rule up to unanimity. We shall not consider the family of demand-revealing processes and other direct revelation mechanisms, which under certain assumptions would dominate the institutions our theory defines as optimal.

The setting in which the constitutional contract is written is described in Section I. The outcomes to be expected from this process are then described starting with the simplest case of two groups of individuals with separable utility functions, who are capable of undertaking only two actions (Sections II and III). Whether symmetric or asymmetric treatment of individuals in the post-constitutional stage is optimal is discussed in Sections IV and V. The consequences of allowing for interdependent externalities, and multiple options are considered in Section V. Allowance is made for more than two groups of individuals in Section VI, and decisionmaking costs are introduced in Section VII. The nature of constitutional rights and obligations is discussed in Section VIII. The main implications of the theory are summarized in Sections IX, and the final section briefly defends the theory against some of the most obvious criticisms against it.

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2 It is common place in economics to derive a positive theory of how a market works under the assumption that the market is perfectly competitive. Although no markets fulfill all of the conditions necessary to qualify as perfectly competitive, some come close enough to make such theories useful in predicting market outcomes. We justify calling ours a positive theory of constitutions in the same way.

## I. The Constitutional Context

Each individual  $\underline{R}$  can undertake one of  $\underline{n}$  possible actions,  $a_{ij}$ ,  $j = 1, n$ . These can range from very private actions like scratching one's ear, to very public ones like bombing the local pub. Among the set of actions might be paying a tax to provide a pure public good. Thus, all *collective* action questions can be viewed as decisions about *individual* actions. A law against driving above 65 mph restricts one's freedom to drive fast. A tax on gasoline to finance highway construction both restricts one's ability to purchase gasoline, and expands one's driving opportunities. All *collective choices* are depicted as decisions about individual actions.

All actions fall into one of three categories: *neutral* actions that affect only the welfare of the actor, *negative externalities* – actions that make other parties worse off, and *positive externalities* – actions that make other parties better off. We shall measure changes in the welfare of individuals by means of utility functions that are defined over own and other persons' actions. Since we deal with situations involving risk and uncertainty, we assume that these utility functions satisfy the von Neumann-Morgenstern utility axioms.<sup>3</sup>

To simplify the analysis, we limit the community to three mutually exclusive decisions with respect to any individual  $\underline{R}$  and her action  $a_{ij}$ : (1) it can *allow*  $\underline{R}$  the freedom to make the action or not, (2) it can *ban*  $\underline{R}$  from undertaking the action, or (3) it can *obligate*  $\underline{R}$  to undertake it. A ban of an action can be regarded as setting an infinite price on the action. A more general approach would replace bans and obligations with fines and bribes. Such an approach would not alter the conceptual framework, but obviously would complicate the analysis greatly. Since we only wish to examine the basic premises and implications of the different approaches to constitutional choice in the literature, we do not introduce this additional degree of complexity.

Any action that creates an externality can lead to conflict in the post-constitutional stage over whether to ban or compel this action, and at the constitutional stage over the political institutions to be used to resolve this

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3 For a clear statement of the von Neumann-Morgenstern axioms see, BAUMOL (1965, Ch. 22). Ng (1984) demonstrates that von Neumann-Morgenstern utilities are cardinal utilities. Strictly speaking, we do not need to assume that individuals actually *have* utility functions that they consciously maximize, only that they act *as if* they did (BINMORE 1994, pp. 50-51).

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post-constitutional conflict. This sort of conflict at the constitutional stage can prevent unanimity over the constitutional contract.

Buchanan and Tullock (1962) obtained unanimous agreement among the individuals who write a constitution by assuming that they are uncertain over their future positions under it. They defended this assumption with the argument that the constitution is expected to be in force for a long period of time. Because of its long run consequences, people are unable to predict their positions and preferences on future issues to be decided under it. To the extent that the long run nature of constitutional choices does introduce uncertainty on the part of those drafting a constitution over its future consequences, a theory that posits the existence of such uncertainty can have predictive value.<sup>4</sup>

Uncertainty over future positions was introduced as a self-imposed condition by John Rawls (1971), John Harsanyi (1955) and more recently Ken Binmore (1994) to provide an ethical underpinning for their theories. Rawls used uncertainty over future position to justify unanimous agreement on a social contract, which then led to unanimous agreement on a constitution. In much the same spirit, uncertainty over future positions leads individuals in Harsanyi's theory to a unanimous choice of a state of the world that maximizes a Benthamite social welfare function. An important difference between Rawls and Harsanyi is that Rawls assumed that the *veil of ignorance* was sufficiently thick to preclude individuals from envisaging their future utilities or calculating the probabilities that they would occupy different positions. In contrast, Harsanyi assumed that individual utility functions satisfy the von Neumann-Morgenstern axioms, as we do, and that individuals could envisage all individuals' utilities in all future states of the world. Each person's ethical preferences lead her to assume that she has an equal probability of being any individual in the society. Binmore assumes, like Rawls, that individuals voluntarily enter into an *original position* in which they are uncertain over their future identities but, like Harsanyi, that in the original position they can envisage the utility functions of all citizens. For both Harsanyi and Binmore the veil of ignorance screens out only information about which future person, an

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4 CALVIN JILLSON (1988, p. 16), although acknowledging the role narrow self-interest played in the writing of the US Constitution argues that the delegates did weigh "the more diffuse and general interests of the community" whenever their personal or constituent interests were not clearly defined. This might be interpreted as the kind of behavior posited here.

individual will be.<sup>5</sup> As we shall see, the assumptions one makes about the "thickness" of the veil of ignorance, i.e., the information citizens have at the constitutional stage, have important consequences for the types of institutions our theory predicts will be in the constitution.

At the post-constitutional stage individuals know who they are, what their preferences are, etc. All private actions have the goal of maximizing utility, as do all collective actions under the voting rules established in the constitution. It is of course possible that an individual will vote to ban an action at the constitutional stage, when she is uncertain about her future preferences, and then in the post-constitutional stage, when she knows her preferences, try to violate the ban. Thus, the community obviously must include in the constitution institutions to ensure *compliance* with it.

Both the utilitarian and the contractarian aspects of our theory have been heavily criticized – and defended. We do not offer a review of this debate and defense of our approach in what is an already long article. In the final section, after the reader is familiar with the theory, we take up a few central criticisms of it.

## II. The Case of Binary Choices

To begin assume that there are only two groups of individuals, Rows (R) and Columns (C). Each can undertake any one of  $n$  possible actions,  $a_{ij}$ ,  $j = 1, n$ , and  $a_{cj}$ ,  $j = 1, n$ . Each individual in a group has the identical utility function defined over his own action and the action of the players in the other group,  $U_i(a_{ij}, a_{ck})$ ,  $i = R, C$ . Since all Rs have identical utility functions, if one R experiences a higher utility from undertaking action  $a_{ij}$  all Rs do, and so we can think of  $U_i(a_{ij}, a_{ck})$  as the utility an  $i$  experiences when all Rs undertake  $a_{ij}$ , and all Cs undertake  $a_{ck}$ . For simplicity we assume that each individual undertakes only one action at a time. Actions  $a_{rn}$  and  $a_{cn}$  are defined to be no action, and are assumed to produce no externalities.

Now consider the possible consequences of Rs and Cs undertaking the actions  $a_{ij}$  and  $a_{cj}$  versus their undertaking the nonactions,  $a_{rn}$  and  $a_{cn}$ . Action  $a_{ij}$  has three possible consequences for an R: (1) it raises his utility relative to

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5 For further discussion of the importance of the thickness of the veil of ignorance and the differences it makes, see NAGEL (1973) and BINMORE (1994, pp. 327-40).



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when he undertakes  $a_m$ , we represent this situation as  $u_j > 0$ , (2) action  $a_j$  does not alter  $\underline{R}$ 's utility,  $u_j = 0$ , or (3)  $a_j$  reduces  $\underline{R}$ 's utility,  $u_j < 0$ . These utility changes can be thought of as the combined effect on  $\underline{R}$  of his own gain or loss from action  $a_j$ , and any gain or loss he experiences from contemplating the effect of this action on the  $\underline{C}$ s. For example, suppose  $a_j$  is  $\underline{R}$ 's smoking a cigar, although he knows this makes all  $\underline{C}$ s worse off. If  $\underline{R}$  suffers sufficient disutility from the knowledge that  $\underline{C}$ s suffer from his smoking cigars, then  $u_j < 0$  for this action even though in the absence of any  $\underline{C}$ s, an  $\underline{R}$  would get positive utility from smoking. The same three possible utility payoffs exist for the action  $a_{cj}$  by the  $\underline{C}$ s.

Each action by an  $\underline{R}$  or a  $\underline{C}$  can have no effect on the other group, or a positive or negative externality. Let us call  $e_j$  the utility change a  $\underline{C}$  experiences from the action  $a_j$  by the  $\underline{R}$ s. A positive externality thus implies  $e_j > 0$ , with  $e_j = 0$ , and  $e_j < 0$ , representing neutral actions and negative externalities respectively.<sup>6</sup> To begin we shall make the simplifying assumption that the utility functions are separable, i.e., the effects of  $\underline{R}$ 's action  $a_j$ , and the external effects of  $\underline{C}$ 's action  $a_j$  are both constants, and their combined effect on  $\underline{R}$ 's utility is simply the sum of the two effects,  $u_j + e_{cj}$ .

Action  $a_j$  has three possible utility consequences for each  $\underline{R}$ , and three possible external effects producing nine combinations of own effect and externality. The same holds for the  $\underline{C}$ s, giving 81 combinations of utility payoffs taking into account the possible actions and interactions of the two groups. The number of combinations can be reduced to 36, however, if we assume that an  $\underline{R}$  does not voluntarily undertake  $a_j$  when  $u_j = 0$ , and likewise for  $\underline{C}$  when  $u_{cj} = 0$ . The remaining 36 combinations are depicted in Matrix 1.

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6 By "externalities" we do mean "pecuniary" externalities that arise, say, because  $\underline{R}$  consumes a scarce resource leaving less for  $\underline{C}$ , but rather what used to be called "technological" externalities or physical externalities like smoke from a factory or a cigar. Recall also that  $u_r \leq 0$  may occur because  $\underline{R}$ s suffer disutility, if they create a negative externality.

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*Matrix 1*

**Collective Action Options when External Effects are Separable**

		Column						
		1	2	3	4	5	6	
		$u_{cj} > 0$ $e_{cj} > 0$	$u_{cj} > 0$ $e_{cj} = 0$	$u_{cj} \leq 0$ $e_{cj} < 0$	$u_{cj} \leq 0$ $e_{cj} = 0$	$u_{ci} > 0$ $e_{ci} < 0$	$u_{ci} \leq 0$ $e_{ci} > 0$	
R o w	1	$u_{rj} > 0$ $e_{rj} > 0$	NN	NN	NN	NN	NB	NO
	2	$u_{rj} > 0$ $e_{rj} = 0$	NN	NN	NN	NN	NB	NO
	3	$u_{rj} \leq 0$ $e_{rj} < 0$	NN	NN	NN	NN	NB	NO
	4	$u_{rj} \leq 0$ $e_{rj} = 0$	NN	NN	NN	NN	NB	NO
	5	$u_{rj} > 0$ $e_{rj} < 0$	BN	BN	BN	BN	BB	BO
	6	$u_{rj} \leq 0$ $e_{rj} > 0$	ON	ON	ON	ON	OB	OO

Notes: N = No action required; B = ban of the action; O = obligation to act.  
First letter applies to Rows, second to Columns

Sixteen of the 36 possible situations require no collective action. The matrix has been constructed so that these cases appear in its upper left hand portion, and are indicated by an NN. The first N indicates that *no* collective decision need be taken with respect to a Row's action  $a_{rj}$ , the second N has the same implication with respect to a Column's actions. Row (column) 2 contains the entries we would expect if an R (C) consumes a private good. The actor experiences a positive utility gain, members of the other group experience no utility change. (Note that since all Rs have the same utility function, if one chooses to consume a private good, all do.)

In the row 3, column 1 entry, R's undertaking  $a_{rj}$  would create a negative externality for the Cs, while a C's undertaking  $a_{cj}$  creates a positive externality for the Rs. Since  $u_{rj} \leq 0$ , however, and  $u_{cj} > 0$ , the Rs find it in their own interest not to undertake the action, while the Cs find it in their interest to do so, and the optimal outcome occurs without the need for any collective decision.

For all entries containing a B, a ban on a group's undertaking the action may be optimal. In row 5, column 1, for example, Rs obtain positive utility

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from  $a_{ij}$  ( $u_{ij} > 0$ ), but the action also produces a negative externality,  $e_{ij} < 0$ . If  $e_{ij}$  is large enough relative to  $u_{ij}$ , a ban on the R's undertaking the action may be socially optimal. Note that when the Cs commit the same action it produces a positive externality, so that *if* a ban in this situation were optimal, it would be an *asymmetric* ban against only the Rs. Entries containing an O designate situations in which an obligation *might be optimal*, because of the existence of positive externalities, with the two squares labeled OB and BO representing the unusual cases of a simultaneous asymmetric ban and obligation being optimal. We return to these and the other asymmetric cases below.

The 16 entries with an NN designate situations in which collective action is *never* required, because each group acting independently of the other produces the optimal outcome. The 20 additional entries designate situations in which bans or obligations *may be optimal*. It is, of course, conceivable that no collective action of any kind is necessary. A single R – Robinson – and C, Crusoe, inhabit an island that is so bountiful that no collective action produces benefits that exceed its costs, and the island is big enough so that all negative externalities are small in comparison with the gains to the perpetrator of the externality.<sup>7</sup> Blissful anarchy is a logical possibility.

In more populous communities and harsher environments, one expects potential gains from collective action. We now explore how optimal collective agreements might emerge out of a two-stage constitutional process in which individuals in the first stage are uncertain over future positions.

### III. The Constitutional Contract

In the context of a two-stage democratic process, uncertainty can take several forms. The minimum uncertainty needed to produce unanimous agreement on a constitution covering the full spectrum of possible actions is over future identities. Assume that each individual at the constitutional stage can forecast all possible future collective actions and their consequences, that is to say the entries in Matrix 1 and all similar matrices for all other pairs of

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7 In the terminology of BUCHANAN AND STUBBLEBINE (1962) all externalities are Pareto irrelevant.

future actions, including the players utility payoffs.<sup>8</sup> If we continue to assume that there are only two groups of players, then this amounts to assuming that the  $u_{rj}$ ,  $u_{cj}$ ,  $e_{rj}$ , and  $e_{cj}$  are known for every possible pair of actions. Further one might assume that the numbers of Row and Column players are known,  $n_r$  and  $n_c$ . Each individual at the constitutional stage knows *everything* about the future *except* whether she will be an R or a C player. We refer to this situation as one of *Identity Uncertainty*. One way to think of identity uncertainty arising is to think of individuals choosing a constitution for their future children. Let R stand for female and C for male. It may be possible to envisage the utilities men and women will experience from a given pair of actions, and the numbers of men and women in the future. But it may not be possible at the constitutional stage to predict the sex of one's unborn children. If so, then identity uncertainty exists.

If individuals at the constitutional stage know the numbers of Row and Column players, the  $n_r$  and  $n_c$ , then they can calculate the probabilities that they are an R or a C. A further degree of uncertainty is added by assuming that these numbers are unknown. R and C now represent ethnic groups and the future population growth of each group is unknown. We refer to this as *Numbers Uncertainty*.

The degree of uncertainty is increased still further by assuming that individuals at the constitutional stage are uncertain about the future utility payoffs – the  $u_{rj}$ ,  $u_{cj}$ ,  $e_{rj}$ , and  $e_{cj}$  – in different situations. We refer to this situation as one of *Payoff Uncertainty*.

Each of these types of uncertainty leads to a different institutional solution to the collective action problem.

### 1. Optimal Collective Action with Only Identity Uncertainty

Every individual at the constitutional stage can envisage the kinds of issues that will come up in the future, the numbers of individuals in each group, and their utility payoffs. They are uncertain over only whether they will be an R or C. Thus, each individual at the constitutional stage can predict for every possible pair of future actions,  $(a_{rj}, a_{cj})$  the box in Matrix 1 in which the community will be located. If the box contains an NN, no collective deci-

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<sup>8</sup> Since each possible "state of the world" is a pair of actions by Rows and Columns, this assumption is equivalent to assuming that each individual at the constitutional stage can envisage all possible future states of world.

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sion is necessary. Many actions are likely to fall into these 16 boxes, so many that the constitution framers may want to include a clause that allows everyone to do anything he chooses *unless the constitution or a law passed in accordance with it specifically forbids or requires an action*, thereby handling all of the possible actions an individual can undertake that affect no one's welfare other than the actor, or have positive external effects on others.

Now consider an action in one of the remaining 20 boxes, say row 5, column 1. Column's action creates a positive externality, and gives Column positive utility. Thus, C need not be compelled to undertake the action, and should not be prevented from doing so. Row's action, on the other hand, creates a negative externality while giving Row positive utility. The rational individual at the constitutional stage, uncertain over whether she will be a future R or C player, chooses to ban future Rs from undertaking the action if the expected utility from such a ban is positive. The probability that an individual is an R,  $\pi_r$ , is  $n_r/(n_r + n_c)$ , while the probability that she is a C is  $\pi_c = n_c/(n_r + n_c)$ . Her expected utility from the action is then

$$\mathcal{E}(U) = \pi_r u_{ij} + \pi_c e_{ij} \tag{1a}$$

If (1a) is negative for an action leading to a box in Row 5, the constitution should ban R's undertaking this action. If (1a) is negative then so too is (1b), which is just (1a) multiplied by  $(n_r + n_c)$ .

$$n_r u_{ij} + n_c e_{ij} < 0 \tag{1b}$$

Condition (1b) reveals the close link between the expected utility maximizing choices of an individual at the constitutional stage and the Benthamite welfare function, the optimal collective decision regarding action  $a_{ij}$  maximizes the sum of the utility changes caused by this action.

If (2) holds for an action leading to any box in Row 6, the constitution framers should agree to obligate R to undertake the action.

$$n_r u_{ij} + n_c e_{ij} > 0 \tag{2}$$

Analogous inequalities with respect to entries in columns 5 and 6 define the conditions under which actions by C should be banned or compelled. Notice that only the boxes in (row 5, column 5) and (row 6, column 6) can *possibly* lead to *symmetric* bans or obligations on all citizens. We discuss symmetric and asymmetric bans and obligations in the next section.

If the only information individuals at the constitutional stage lacked was knowledge of which future citizen they would be, then the constitution could contain all of the bans and obligations that would ever be needed. Strictly

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speaking, such a situation involves only Knightian risk, rather than true uncertainty, and individuals at the constitutional stage have all of the information they need to calculate their expected utilities for every pair of actions by Rows and Columns. If in 20 or 100 years time, the threat of a flood would require the construction of a dike, the constitution framers could forecast this event, the future preferences of citizens, and determine their tax and effort obligations. These could then be written into the constitution. No second stage in the democratic process would be needed. From the point of view of individuals at the constitutional stage, the constitution could optimally resolve all issues for all time. This then is our first proposition.

**Proposition 1.** Identity uncertainty combined with full knowledge of preferences and numbers of all future citizens allows individuals at the constitutional stage to specify all future bans and obligations so as to maximize their expected utility in the post-constitutional stage. No second stage of collective decisionmaking is required.

The assumptions in Proposition 1 are essentially those that John Harsanyi (1955, 1977) made in determining principles for moral choices. Each individual can envisage the utility of every individual in every possible future state of the world, and the probabilities that she will be any of those individuals. She chooses that social state, i.e., combination of actions for Rows and Columns, that maximizes her expected utility. This choice maximizes the sum of the future utilities of the community, and thus can be viewed as maximizing a Benthamite social welfare function.<sup>9</sup> If only identity uncertainty is present at the constitutional stage, then the constitution specifies all actions for all future citizens so as to maximize the Benthamite sum of individual utilities.

If the constitution does not specify institutions that induce individuals to abide by its provisions in the second stage, it will not in fact maximize the sum of individual utilities. To ensure *compliance* Ken Binmore (1994) de-

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9 HARSANYI (1955) adds the assumptions that social preferences must also satisfy the von-Neumann-Morgenstern rationality axioms, and that society is indifferent between two states  $\underline{x}$  and  $\underline{y}$ , if each individual is indifferent between them. These additional axioms allow him to prove that the ethical choices of individuals, which consist of maximizing their expected utilities under the assumption that they have an equal probability of being any future citizen, are equivalent to maximizing a Benthamite social welfare function. See, also, MUELLER (1973).

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rives a minimax characterization of the social welfare function. Binmore, like Harsanyi, assumes only identity uncertainty in the original position. The social contract/constitution that would produce his social welfare function could, therefore, specify all of the necessary actions of those who are a party to it. No second stage of the political process would be needed.

The omniscience over the future events underlying Proposition 1 is obviously extreme. Let us add another degree of uncertainty, therefore, namely over the numbers of future citizens in the two groups.

### 2. Optimal Collective Action with Identity and Numbers Uncertainty

We continue to assume that individuals at the constitutional stage know and can compare the  $u_{rj}$ ,  $u_{cj}$ ,  $e_{rj}$ , and  $e_{cj}$  associated with all future actions by the two groups. Thus, the optimal collective decision with respect to an  $\underline{R}$ 's action that leads to rows 5 or 6 in Matrix 1 must still satisfy equations (1) or (2). With the  $n_r$  and  $n_c$  now unknown, equation (1b) requires for an action in row 5 that the following condition be satisfied

$$n_r/n_c < -e_{rj}/u_{rj} \tag{3a}$$

and with respect to a ban of  $a_{cj}$ ,

$$n_c/n_r < -e_{cj}/u_{cj} \tag{3b}$$

Since the righthandsides of (3a,b) are assumed to be known, the optimal collective choices can be made once the numbers of individuals in the two groups are established. This information can be obtained simply by citizens voting in the second stage of the political process on the bans. It is in an  $\underline{R}$ 's interest to vote against a ban of  $a_{rj}$ , and in a  $\underline{C}$ 's interest to vote for it. The constitution framers can ensure that the optimal collective choice is made with respect to the ban of this action by requiring a referendum with a majority of votes in favor of a ban satisfying (3a). For example, if the utility gain to an  $\underline{R}$  from  $a_{rj}$  is known to be three times the loss imposed on a  $\underline{C}$  from the action ( $u_{rj} = -3e_{rj}$ ), then the expected utility of the constitution framers is maximized by requiring that a future ban against  $\underline{R}$ 's undertaking this action obtain a 3/4ths majority or more.

**Proposition 2.** With  $u_{rj} > 0$ ,  $u_{cj} > 0$ ,  $e_{rj} < 0$ , and  $e_{cj} < 0$ , identity and numbers uncertainty combined with full knowledge of the preferences of all future citizens allows individuals at the constitutional stage to maximize their expected utility by specify-

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ing a voting rule for the second stage of collective decision-making to decide all future bans against  $a_j$  ( $a_{cj}$ ) such that condition 3a (3b) is satisfied.

From equation 2 we can analogously derive the conditions for obligating  $a_{rj}$  and  $a_{cj}$

$$n_r/n_c > -e_{rj}/u_{rj} \quad (4a)$$

$$n_c/n_r > -e_{cj}/u_{cj} \quad (4b)$$

From which we obtain

**Proposition 3.** With  $u_{rj} < 0$ ,  $u_{cj} < 0$ ,  $e_{rj} > 0$ , and  $e_{cj} > 0$ , identity and numbers uncertainty combined with full knowledge of the preferences of all future citizens allows individuals at the constitutional stage to maximize their expected utility by specifying a voting rule for the second stage of collective decision-making to decide all future obligations of  $a_j$  ( $a_{cj}$ ) such that condition 4a (4b) is satisfied

In the special case that  $u_{rj} = -e_{rj} > 0$ , the expected utility of an individual at the constitutional stage is maximized, if the ban against  $a_j$  is decided using the simple majority rule. This is essentially the Rae-Taylor theorem in favor of the simple majority rule, and rests clearly on the assumption of equal intensities on both sides of the issue.<sup>10</sup>

When the equal intensity condition holds with respect to symmetric negative externalities, i.e.  $u_{rj} = -e_{rj} > 0$ , and  $u_{cj} = -e_{cj} > 0$ , then the simple majority rule is the optimal voting rule to decide whether to ban action  $a_{rj}$  by Row players, and whether to ban  $a_{cj}$  by Column players. If Rows are in the majority they will vote to ban  $a_{cj}$ , and to allow themselves to undertake  $a_{rj}$ . The relentless logic of expected utility maximization coupled to the equal intensity assumption leads to "a tyranny of the majority," as the optimal outcome of the process of choosing a voting rule that maximizes the expected utility of a citizen at the constitutional stage. The majority votes to allow themselves to do that which they forbid the minority from doing.

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10 See, RAE (1969), TAYLOR (1969) and RAE AND SCHICKLER (1997). BUCHANAN AND TULLOCK (1962, pp. 128-30) also stress the importance of assuming equal intensities in choosing the simple majority rule.



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**Proposition 4.** With symmetric negative (positive) externalities, and equal intensities on the two sides of the issue (i.e.,  $u_{rj} = -e_{rj}$ , and  $u_{cj} = -e_{cj}$ ), identity and numbers uncertainty combined with full knowledge of the preferences of all future citizens implies that the simple majority rule is the optimal voting rule to decide whether to ban (obligate) actions  $a_{rj}$  and  $a_{cj}$  by future Row and Column players, respectively. The application of this voting rule in the second stage of collective decisionmaking under these assumptions *must* lead to an *asymmetric* ban (obligation) of the actions  $a_{rj}$  and  $a_{cj}$ .

(Note that the equal intensities assumptions imply that the righthandsides of both (3a) and (3b) equal 1. For a symmetric ban to be optimal,  $n_r/n_c < 1$ , and  $n_c/n_r < 1$  would both need to hold, which is impossible.)

Conversely, we can see that a symmetric ban can be optimal with identity and numbers uncertainty, only when the payoffs are known and are such as to make *different* voting rules optimal for the respective bans. For example, if  $u_{rj} > 0$ ,  $u_{cj} > 0$ ,  $-e_{rj}/u_{rj} = 1$ , and  $-e_{cj}/u_{cj} = 2$ , then the simple majority rule would be optimal for banning  $a_{rj}$ , while  $a_{cj}$  should be banned, if even a third of the community chooses to do so. If  $1 < n_c/n_r < 2$ , Columns are able to ban  $a_{rj}$ , but are not able to block Rows from banning  $a_{cj}$ .

Conditions (3a,b) require that the majority required to ban an action be higher, the smaller is the gain in utility to an individual in favor of a ban relative to the gain in utility for the person who is allowed to act. In the limit, as the righthandsides of (3a,b) approach infinity, the constitution framers would allow a future ban, only if the community unanimously voted in favor of it.

Conversely, as  $-e_{rj}$  grows large relative to  $u_{rj}$  the constitutional convention will wish to establish a presumption against action  $a_{rj}$ . This could be accomplished through a ban on  $a_{rj}$  in the constitution with a provision that it could be lifted with a majority of  $m_j \geq |e_{rj}| / (|e_{rj}| + u_{rj})$ . In the limit, as the utility loss to a Column becomes very large relative to the gain to a Row from the action, its constitutional ban could be lifted only by a unanimous vote of the community.

Analogous considerations once again apply with respect to obligations.

### 3. Optimal Collective Action with Identity, Numbers and Payoff Uncertainty

For many sorts of actions the most realistic assumption to make is that an individual at the constitutional stage is uncertain over identities, numbers and future utility payoffs from these actions. For example, it might be reasonable to assume that in 1787 an individual could compare the utility he perceived a smoker obtained from smoking, and the negative externality this action caused at that time, but he would not have been able to envisage very accurately future citizens' utilities and disutilities from smoking, or the numbers of smokers and nonsmokers. More generally, he could not anticipate whether other stimulants similar to tobacco would be discovered, their possible positive and negative effects, and so on. Both the  $u_{ij}$ s and the  $e_{ij}$ s in equations (1) and (2) are in these situations unknown.

If the constitution framers can envisage the distribution of utility changes associated with a particular action, then we can simply substitute the expected values of  $u_{ij}$  and  $e_{ij}$  into our optimality conditions, and proceed as above. If we think of the constitution as governing the collective decisions of the community over a very long period, however, even this assumption may be questionable. On the other hand, if all elements in equations (1), (2) and (3) are unknowns, no procedure for making future collective choices can be written into the constitution that maximizes the expected utility of someone at the constitutional stage.

Thus, when reasonable predictions of the utility gains and losses from particular actions cannot be made, the constitution might simply be silent on how future generations should decide them. Although this approach would be intellectually honest, it would impose on future generations the difficult task of both choosing and applying voting rules to deal with many potentially divisive issues, once their preferences were fully known.

Rather than saddle future generations with such choices, the constitution framers might make "an educated guess" as to the magnitudes of  $u_{ij}$  and  $-e_{ij}$  and define a voting rule accordingly. But what is a reasonable guess,  $-e_{ij}$  is half of  $u_{ij}$ , three times as great? Assuming they are of equal magnitude constitutes a form of Schelling point, or alternatively might be interpreted as an application of the principle of insufficient reason to this problem. With  $u_{ij}$  and  $-e_{ij}$  equal, conditions (3a,b) require that any bans of actions that fit entries in row or column 5 be resolved using the simple majority rule. Conditions (4a,b) demand the simple majority rule for obligations in situations that fit

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entries in row or column 6. We have then a normative justification for the ubiquitous use of this voting rule. Unable to estimate the future gains and losses from many collective decisions, the constitution writers assume that they are equal, and opt for the voting rule that maximizes their expected utility under this assumption.

### IV. Symmetric and Asymmetric Bans and Obligations

Although asymmetric bans or obligations are likely to be optimal from the point of view of an individual at the constitutional stage who is uncertain of her future identity, they may often be infeasible. Suppose that both Rows and Columns get utility out of being free to drive faster than 65 mph when they so choose ( $u_{rj} > 0$  and  $u_{cj} > 0$ ). Rows are skillful and prudent drivers and only drive at these speeds when there is no danger of their harming anyone, ( $e_{rj} = 0$ ). Columns, on the other hand, are poor and somewhat reckless drivers ( $e_{cj} < 0$ ). From behind the veil of ignorance, the community could unanimously agree to ban Columns from driving at more than 65 mph, while allowing Rows to drive at whatever speed that they choose. But unless Rows and Columns can be identified prior to their stepping behind the wheel, such a ban will be unenforceable. Since both Rows and Columns prefer having the freedom to drive above 65, Columns will simply pretend to be Rows. Given the infeasibility of enforcing an asymmetric ban, a symmetric ban may be optimal. This will be the case when the expected utility of someone at the constitutional stage from a total ban is positive, i.e., when (5) is satisfied

$$n_r u_{rj} + n_c e_{rj} + n_c u_{cj} + n_r e_{cj} < 0 \quad (5)$$

When (5) does not hold the optimal rule will be a symmetric freedom to drive above 65. An analogous condition with the inequality reversed applies to symmetric obligations in the presence of positive externalities. Thus, owing to the transaction costs of enforcing asymmetric bans and obligations, more rules may need to be applied symmetrically than is suggested by Matrix 1.

Identifying those who have different preferences and/or who generate different externalities is, on the other hand, often feasible, thus so too are asymmetric bans, for example, a ban against those who are under 21 consuming alcohol. Thus, an expected utility maximizing constitution would impose

asymmetric bans, whenever differences in utility payoffs and external effects from actions can be readily identified.

Row 6, column 5, and row 5, column 6 in Matrix 1 contain entries that may seem highly unlikely – a simultaneous ban and obligation for the two groups with respect to the same action. Nevertheless, such asymmetric treatments of different groups are both logically possible, and observable in practice. A somewhat archaic and sexist example of this sort of asymmetry would be a constitutionally defined obligation for men to serve in the army, and a ban against women serving. Such asymmetric treatment of these two groups could arise, if men got negative utility from being in the army, but their service generated positive externalities, while women fancied being in the army, but their service generated negative externalities. Under these conditions, citizens who were uncertain of their future sex could unanimously agree on an asymmetric ban and obligation regarding military service.

## V. Multiple Choices and Interdependent Utilities

In Sections II and III we assumed that each individual confronted a binary choice, to undertake a given action or not, and the community confronted the discrete choices of allowing, banning or compelling the action. We also assumed separable external effects. These assumptions are realistic with respect to many collective choices. Slavery, abortion, and legalized drugs are just three examples of issues that many people view as binary choices. The loss Column experiences when a Row steals from him may reasonably be assumed to be independent of whether Column is also a thief.

In other situations more complex relationships and choices must be assumed, however. The risk of harm that Rs experience from Cs' driving depends on whether the Rs are also driving. Cars can be driven at any one of a continuous range of speeds. Money to provide a pure public good can be contributed in various amounts. To handle such cases, we need to think of  $a_j$  as a continuous variable, or a set of possible actions differing with respect to intensity and perhaps other characteristics. A community seeking the benefits from having all citizens commit  $a_j$  must choose a level of  $a_j$  for each citizen. To see what is involved, let us assume that for a particular activity the  $a_j$  are scalars, and that Rows and Columns have twice differentiable utility functions defined over these two scalars of the following forms

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$$U_R = U_R(a_{rj}, a_{cj}) \text{ and } U_C = U_C(a_{cj}, a_{rj})$$

An individual at the constitutional convention wishes to maximize his expected utility, which again amounts to maximizing the Benthamite function

$$W = n_r U_R(a_{rj}, a_{cj}) + n_c U_C(a_{cj}, a_{rj}) \quad (6)$$

which yields the first order conditions

$$\frac{\partial W}{\partial a_{rj}} = n_r \frac{\partial U_R}{\partial a_{rj}} + n_c \frac{\partial U_C}{\partial a_{rj}} = 0 \quad (7)$$

$$\frac{\partial W}{\partial a_{cj}} = n_r \frac{\partial U_R}{\partial a_{cj}} + n_c \frac{\partial U_C}{\partial a_{cj}} = 0$$

If both the utility functions and the numbers of Row and Column players are known, we again have essentially the situation first analyzed by Harsanyi (1955), and the constitution framers stipulate the levels of each action ( $a_{rj}$ ,  $a_{cj}$ ) so as to maximize the welfare function given in (6).

When the utility functions  $U_R$  and  $U_C$  are known, but the  $n_r$  and  $n_c$  are not, one might wish to define a voting rule to reveal the  $n_r$  and  $n_c$ . When  $U_R$  and  $U_C$  are continuous functions of  $a_{rj}$  and  $a_{cj}$ , however, such an option no longer exists. From (7) we can solve for the optimal relationships between the numbers of individuals in each group, and the marginal utilities from each action.

$$\frac{n_r}{n_c} = - \frac{\partial U_C / \partial a_{rj}}{\partial U_R / \partial a_{rj}} \quad (8)$$

$$\frac{n_r}{n_c} = - \frac{\partial U_C / \partial a_{cj}}{\partial U_R / \partial a_{cj}}$$

If both own marginal utilities from  $a_j$  are positive ( $\partial U_R / \partial a_{rj} > 0$ , and  $\partial U_C / \partial a_{cj} > 0$ ), and the actions cause negative externalities, then (8) defines conditions that determine the optimal levels of both actions. But no voting rule leads to this outcome. If the simple majority rule is used to decide the

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levels of  $a_{rj}$  and  $a_{cj}$ , and the Rows are in the majority, they will not choose to require levels of  $a_{rj}$  and  $a_{cj}$  that satisfy (8). Instead they will allow themselves full freedom to act, so that  $\partial U_R/\partial a_{rj} = 0$ , and the righthandside of the first equation in (8) goes to infinity, while totaling banning  $a_{cj}$ . When multiple degrees of an action are possible, and utility varies with the level of the action, no qualified majority rule *alone* can be relied upon to determine the optimal level of the action.

The potential scope for a tyranny of the majority is obviously great, when the levels of action possible vary over a wide range. Moreover, unlike the situation when only two possible choices exist – action or no action – with multiple actions the simple majority rule is likely to produce an outcome that deviates greatly from that which would maximize the expected utility of an individual at the constitutional stage. A closer approximation to the levels of actions that are optimal might be achieved in this situation, if the constitution coupled the choice of a qualified majority to decide the level of an action with a symmetry constraint. Whatever level of the action that is allowed (required) of one group must pertain to the other. With this symmetry condition, the simple majority rule in use, and Rows, say, in the majority, they would choose a level of  $a_j$  such that  $\partial U_R/\partial a_{rj} = -\partial U_R/\partial a_{cj}$ , i.e., a level that equates the denominators of the righthandsides of the two equations in (8). If the utility functions of the Rows and Columns were similar, then this level of activity would also equate the numerators, and the righthandsides of (8) would both equal 1. Although the levels of  $a_{rj}$  and  $a_{cj}$  would not maximize (6), given  $n_r$  and  $n_c$ , they would most likely come much closer to achieving this outcome than allowing one group to set different levels of  $a_j$  for each group so as to maximize its utility.<sup>11</sup>

We conclude that a constitutional convention that expected future members of the community to have similar utility functions defined over continuous levels of different activities could achieve higher expected utility, if it

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11 With diminishing marginal utility from undertaking  $a_{jr}$ , the gain to a Row from going from the constrained level of  $a_{jr}$ , where  $\partial U_R/\partial a_{jr} = -\partial U_R/\partial a_{jc}$ , to the level of  $a_{jr}$ , where  $\partial U_R/\partial a_{jr} = 0$  will tend to be less than the loss in utility, if Columns are constrained and  $a_{jc} = 0$ . Similarly, with rising disutility from  $a_{jc}$ , the loss to a Row from going from the constrained outcome to Columns' being unconstrained will tend to exceed the gain when Rows can constrain  $a_{jc} = 0$ . BUCHANAN AND CONGLETON (1998) present examples of situations in which the imposition of a symmetry constraint can improve the realized aggregate utilities of a community.

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coupled the use of the simple majority rule to the requirement that decisions made with this rule apply uniformly across the community.

### VI. Expanding the Number of Groups of Individuals

#### 1. Binary Choices

We consider now the effects of expanding the number of groups with different sets of preferences. Let us return to the simple case of separable utilities and binary choices. There are now two Row groups which get positive utility from action  $\underline{a}_j$ , but still only one Column group which, let us assume, experiences the same loss of utility, when either Row group acts. Simplifying the notation by dropping the subscript identifying the action  $j$ , gives us  $u_{1r} > 0$ ,  $u_{2r} > 0$ ,  $e_r < 0$ , and  $u_{1r} \neq u_{2r}$ .

With only identity uncertainty, the participant in the constitutional convention can still calculate her expected utility under a ban of the action, and places such a ban in the constitution, if

$$n_{1r}u_{1r} + n_{2r}u_{2r} + n_c e_r < 0 \tag{9}$$

Since the utility changes are assumed to be known under numbers uncertainty, we can set  $u_{2r} = \alpha u_{1r}$ , and rearrange (9) to obtain

$$\frac{n_{1r} + \alpha n_{2r}}{n_c} < - \frac{e_r}{\mu_{1r}} \tag{10}$$

If the  $n_i$  are unknown knowledge of the individual utility changes caused by the action no longer allows the constitutional convention to specify a simple voting rule to reveal the size of each group. By voting against a ban, an individual reveals herself to be a Row, but not whether she belongs to group 1 or 2. Without this information, no qualified majority rule can ensure that (10) is satisfied, even when  $u_{1r}$ ,  $e_r$ , and  $\alpha$  are known.

Nevertheless, (10) can provide some guidance as to the choice of the optimal voting rule. If the equal intensity condition holds with respect to Rows in group 1 and Columns ( $-e_r = u_{1r}$ ), for example, and members of Row group 2 experience more utility than those in group 1 from the action ( $\alpha > 1$ ), then (10) tells us that the optimal qualified majority to introduce a ban *must* be above the simple majority. More cannot be said without introducing additional assumptions about the  $\underline{n}_s$ . If the constitution framers know the distribu-

tions of  $n_s$  for *all* groups, they can substitute the expected values of these  $n_s$  into (9), and again decide immediately whether or not to ban the action at the constitutional stage. For the special case where they know the distributions of the  $n_s$ s, but not that of  $n_c$ , (10) could be used to define the optimal voting rule. For example, if  $\mathcal{E}(n_{1r}) = \mathcal{E}(n_{2r})$ , and  $\alpha = 2$ , (10) demands banning the action when at least 3/4ths of the community favors a ban.<sup>12</sup>

As the numbers of Row and Column groups with different utility changes from a given action grows, it becomes more difficult to define an optimal qualified majority rule, even with knowledge of what these utility changes are. When the number of groups is not too large, however, knowledge of the utility changes expected from a given action could provide guidance as to the optimal voting rule to use to regulate this action as in the above example.

## 2. Multiple Choices

With continuous actions and more than two sets of preferences the decision calculus is complicated still further. The constitution framers must now anticipate that any voting rule is likely to lead to bargaining and bickering among the different groups, and consequently must weigh future *decision-making costs* when choosing a voting rule. This problem is taken up in the next section.

However, in some situations continuous actions and multiple groups decisionmaking costs need not play a significant role. Entries in Row 5, Columns 3 or 4 of Matrix 1 involve one-way negative externalities like smoking and driving at high speeds, or as in Row 6, Columns 3 or 4 a one-way positive externality. These issues can be thought of as single dimensional, ranging from out right prohibitions and obligations to blanket freedoms. The collective action involves the resolution of a conflict among the citizens over the optimal severity of a ban or obligation. It is reasonable to assume that individuals have single-peaked preferences with respect to these sorts of issues,

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12 Let  $\mathcal{E}(n_{1r}) = \mathcal{E}(n_{2r}) = n_r$ . Then (10) becomes

$$n_r + 2 n_r \text{OVER} n_c < 1 \tag{F1}$$

from which  $3n_r < n_c$  and  $4n_r < n_c + n_r$  and

$$\frac{n_r}{n_c + n_r} < \frac{1}{4} \tag{F2}$$



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i.e., each person favors a ban or obligation of a particular degree of severity with utility falling off as the severity chosen deviates from this ideal level.

To illustrate what is involved, assume that each individual  $i$  has the single-peaked utility function,  $U_i = K_i - b_i(a_i - a)^2$ , defined over the scalar  $a$ ,  $0 \leq a \leq \infty$ .  $K_i$  represents the maximum utility that an  $i$  can obtain, which occurs when  $a = a_i$ ;  $b_i$  is an intensity weight measuring the speed at which  $i$ 's utility declines as  $a$  moves away from  $a_i$ . There is no need to define groups now, any two individuals  $i$  and  $j$  can have the same ideal points. With only identity uncertainty individuals at the constitutional stage can choose the  $a^*$  that maximizes their expected utility and place it directly into the constitution. This  $a^*$  must satisfy the first order condition

$$\sum_{i=1}^n 2 b_i (a_i - a) = 0 \quad (11)$$

$a^*$  is a weighted average of the individual ideal points, with the intensity factors,  $b_i$ , as weights.

$$a^* = \frac{\sum_{i=1}^n b_i a_i}{\sum_{i=1}^n b_i} \quad (12)$$

With shapes and positions of the utility functions known, the optimal level of action  $a^*$  can again be written into the constitution.

A natural way to think of numbers uncertainty in this situation is to assume that the  $b_i$  weights are known for each utility function, but that the position of each ideal point is unknown. There could be one person with the ideal point  $a_i$ , 100 persons, or perhaps no one. With single-peaked preferences of the type assumed, there is unfortunately no qualified majority  $m$  that will reveal the  $a^*$  satisfying (12).

One interpretation of the equal intensity assumption is that all individuals have the same  $b_i$ s. This transforms (12) into the arithmetic mean of the ideal points, but this alone does not allow the constitution framers to choose the simple majority rule to maximize their expected utilities. With single-peaked preferences and a single-dimensional issue, the simple majority rule chooses the *median* of the distribution of ideal points, while the optimal choice would be their *mean*. To find this optimum, information about the exact positions of the ideal points must be revealed. The simple majority rule reveals only the numbers of ideal points lying to the left or right of a particular point, however.

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The mean and median are identical, of course, if the distribution of ideal points is symmetric. Thus, if the constitution framers envisage a symmetric distribution of ideal points on some single-dimensional issue, but cannot predict its position, the simple majority rule could be used to define the optimal level of this action to allow. If a positively skewed distribution of ideal points were envisaged, a qualified majority rule greater than the simple majority would be optimal.

For some sorts of issues, the constitution framers may be able to form judgments about the pattern of intensity differences. If they envisaged that preference intensity rises as the most preferred level of an action rises,  $b_i = f(a_i)$ ,  $f'(a_i) > 0$ , the framers would also choose, *ceteris paribus*, a qualified majority rule greater than the simple majority to place any constraints on individuals undertaking this action.

Thus, not surprisingly, as the number of different utility functions increases, the constitution framers' ability to select a voting rule that maximizes their expected utilities declines. With single-dimensional conflict issues, they may only be able to specify whether the voting rule ought to be the simple majority rule, or some higher qualified majority, but not what this majority should be. When they can make no predictions about the distribution of future citizens' ideal points, even this may not be possible. While the task of selecting a voting rule that maximizes expected utility at the constitutional stage becomes more difficult as the number of groups increases, the problem of a tyranny of the majority subsides. If, for example, each individual has a different ideal point for a single-dimensional conflict action, any level of the action chosen corresponds to the ideal point of at most one voter, and so the remaining voters are *all* "tyrannized" to some degree,<sup>13</sup> but for many the utility loss from this tyranny is small.

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13 If the level is decided using the simple majority rule, and the number of voters is odd, it corresponds to the ideal point of the median voter. With an even number of voters, it could correspond to a point between the ideal points of the two median voters.

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### VII. Decisionmaking Costs

Consider again the two group, one action case of Matrix 1. In row 5, Rows obtain positive utility from an action that causes a negative externality. It is tempting to argue that no collective action is necessary in these cases, and to rely on the Coase theorem to ensure that a Pareto optimal outcome is obtained (Coase, 1960; Bernholz, 1997). Columns can simply bribe Rows not to act.

In thinking about the resolution of these conflicts at the constitutional stage, however, such a way around these sorts of difficulties seems illegitimate, at least with respect to the first four entries in Row 5. To prevent Rows from acting Columns must offer them a sufficiently large bribe. But with what can Columns bribe Rows if, at the constitutional stage, property rights are now yet secure? Thus, with respect to the kinds of *conflict* issues that are represented in the first four boxes of Rows 5 and 6, it seems reasonable to assume that Coasian solutions are not feasible, and provision in the constitution must be made for their optimal resolution.

This argument does not hold for the four entries in the bottom right-hand corner of Matrix 1, where rows 5 and 6, and columns 5 and 6 intersect. Now each person does have something to trade – her freedom to undertake action  $a_j$ . These four cases can give rise to different forms of prisoners' dilemmas, and the optimal outcome could conceivably be reached by requiring that bans and obligations of these actions be made jointly using the unanimity rule. In discussing decisionmaking costs, therefore, we distinguish between situations, which potentially give rise to prisoners' dilemmas (the intersections of rows 5 and 6 with columns 5 and 6), and the other 16 entries in these two rows and columns, which we refer to as conflict issues.

#### 1. Prisoners' Dilemmas

In a prisoners' dilemma, a unanimous agreement to adopt the cooperative strategies is possible *without* any uncertainty over who the players are or their utility pay-offs.<sup>14</sup> Thus, *even* when none of the three forms of uncertainty is present at the constitutional stage, for actions giving rise to prisoners' dilem-

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14 For an extended discussion of situations in which uncertainty is *not* required to reach an agreement at the constitutional stage, see MÜLLER (1998).

mas, the players have the incentive to agree to the jointly cooperative actions, and this agreement can, in principle, be written directly into the constitution.

Unfortunately, of course, in a prisoners' dilemma each individual has an incentive to break the agreement in the post-constitutional stage. To achieve the gains from cooperation, agreements to cooperate must also provide incentives to cooperate as, for example, penalties for noncooperation. An effective ban of stealing must stipulate the penalty to be imposed if the ban is violated. The optimal penalties to deter stealing a loaf of bread may differ from those to deter robbing a bank. It may be optimal to punish armed robbery more severely than embezzlement, and so on. Thus, collective decisions in many prisoners' dilemma situations do not simply involve the specification of the desired actions by each party – do not steal – they also involve multiple possible retaliatory actions by the community.

Contributions to the provision of a pure public good also have the characteristics of a prisoners' dilemma, but in this case the *action* involved – how much each person contributes – is essentially a continuous variable. The optimal contribution of each citizen depends on her preferences and income, and the number of groups with different preferences for the public good is likely to exceed two. In communities with large numbers of individuals with different preferences and incomes, the *decisionmaking costs* of determining each individual's contribution, the penalty for failing to contribute, and so on, will be large. When these costs are taken into account, some less than unanimity rule may prove optimal.

Once collective decisions are made with a qualified majority rule, however, an individual loses the protection afforded by the unanimity rule against decisions that make her worse off. In their pioneering discussion, Buchanan and Tullock (1962, pp. 63-91) named the consequent losses imposed on some citizens the *external costs of collective decisionmaking*. Thus, the decision-making costs associated with the unanimity rule convert a potentially cooperative game to find a Pareto-preferred set of actions into a conflict between those in the winning coalition who obtain net benefits from the collective action, and those in the losing coalition who do not. Uncertainty reappears at the constitutional stage over whether a given individual will be in a future winning or losing coalition.

The impact of decisionmaking costs on the choice of collective decision rule can be studied under the assumption that there are again only two groups in the community, the winners and the losers under a given collective decision. Let  $\underline{w}$  be the gain in utility an individual at the constitutional stage ex-

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pects from a particular collective action should he be on the winning side on this issue,  $s$  the loss if he is on the losing side. The probability that the individual is on the winning side of issue  $j$ ,  $p(m_j)$ , is a function of the majority required to pass it,  $m_j$ , where  $p'(m_j) > 0$ , and  $p''(m_j) < 0$  up to  $m_j = 1$ . In choosing a voting rule to decide this issue, an individual at the constitutional stage must weigh the gain in utility he expects from increasing the majority required to pass an issue, and thus his chances of being on the winning side, against the decisionmaking costs of finding an action that can win a higher majority. Let us call these  $d(m_j)$ , where it is reasonable to assume  $d'(m_j) > 0$ , and  $d''(m_j) > 0$  up to  $m_j = 1$ . A member of the constitutional convention must thus choose  $m_j$  to maximize

$$\mathcal{E}(U) = p(m_j)w - [1 - p(m_j)]s - d(m_j) \quad (13)$$

which yields the  $m_j$  satisfying

$$p'(m_j)(w + s) = d'(m_j) \quad (14)$$

The lefthandside of (14) is the marginal gain in utility expected from increasing the required majority; the righthandside is the marginal increase in decisionmaking costs. The voting rule that maximizes the expected utility of someone at the constitutional stage balances these marginal gains and costs of alternative required majorities.

If we think of the voting process as a search for information about individual preferences, e.g., the willingness of each individual to contribute to the provision of a public good, it seems reasonable to think of marginal decisionmaking costs rising continuously with the majority required to pass an issue, as it becomes more and more difficult to discover a contribution that makes an individual with outlier preferences better off, and the incentive to engage in strategic holdouts increases. An alternative way to envisage the process, however, is as a search for winning coalitions. Each new proposal may be quite different from its predecessor and win support from a quite different set of voters. When the voting process is of this form, the possibility of cycling must be entertained. Decisionmaking costs might then actually *fall* as the required majority is increased over some range of  $m_j$ , because increasing  $m_j$  lowers the probability of a cycle.<sup>15</sup>

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<sup>15</sup> Under assumptions that seem reasonable for multidimensional pure public goods, CAPLIN AND NALEBUFF (1988) have proved that the probability of cycles falls as the required majority increases, reaching zero at an  $\underline{m}_j$  of 0.64.

## 2. Direct Conflicts

The other 16 entries in Rows and Columns 5 or 6 of Matrix 1 involve one-way externalities in which some form of ban or obligation may be optimal. As discussed in the previous section, these issues can often be thought of as single-dimensional conflicts. The unanimity rule is not an option for resolving such conflicts, unless side payments are also allowed as a way of securing a Coasian exchange. For pure conflict issues uncertainty at the constitutional stage is necessary to achieve unanimous agreement on a constitutional ban or obligation, or even on a voting rule for determining future bans or obligations.

With a single-dimensional issue an individual has no incentive to vote insincerely. Proposals to restrict an action can be made in increasing degrees of severity. The winning proposal under an  $\underline{m}_j$ -qualified majority rule will impose a restriction corresponding to the ideal point of the voter at the  $\underline{m}_j$ th percentile of the distribution of voter ideal points. The choice of  $\underline{m}_j$  amounts to the choice of the percentile of the distribution of ideal points where the restriction will lie. The time required to select one percentile should not differ much from the time to select another,  $d'(\underline{m}_j)$  might reasonably be assumed to be zero. The constitutional convention can treat decisionmaking costs as a constant deadweight loss. When choosing the optimal majority to resolve single-dimensional conflict issues, only the effects of this choice on the expected utility pay-offs need be weighed. Future decisionmaking costs should not be a factor.

## VIII. Rights and Obligations

Consider equation (3a) once again. As the righthandside approaches zero, the majority required to prohibit  $\underline{a}_j$  approaches unanimity. Now there are two ways in which the righthandside of (3a) might approach zero. First, of course, it equals zero, if  $e_{ij} = 0$ . If  $\underline{C}$ 's utility is unaffected by  $\underline{a}_j$ , then  $\underline{R}$  should be free to act, and (3a) calls for a unanimous vote of the community in the second stage of the political process to prohibit her from doing so. But, there are a myriad of actions,  $\underline{a}_j$ , that benefit  $\underline{R}$  and have no impact on others. It would be impossible for the constitution to list all of these, and specify that they could be abridged only through a unanimous vote of the community. As

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noted above, such actions seem most efficiently handled through a blanket provision that allows all actions that have not been specifically prohibited.

The ratio  $-e_{rj}/u_{rj}$  also approaches zero even when  $-e_{rj} > 0$ , as  $u_{rj}$  becomes very large. In this case individuals at the constitutional stage who thought that they might be a future R could not simply count on a broadly defined freedom to do what one chooses to protect their freedom to do  $\underline{a}_j$ . Because Cs experience a utility decline from  $\underline{a}_j$ , future Cs may try to prohibit Rs' from doing  $\underline{a}_j$ . Such restrictions might be imposed by a simple majority vote and result in a loss in net utility, if an R's freedom to do  $\underline{a}_j$  was not explicitly protected. Individuals who are uncertain of whether they would be a future R or C would maximize their expected utility at the constitutional stage by explicitly requiring that a proposal to restrict the freedom to do  $\underline{a}_j$  must pass by a supramajority, which could range up to unanimity.

If Rs experience a great loss from not doing  $\underline{a}_j$ , they would only vote for a proposal to restrict their freedom to do  $\underline{a}_j$ , if they were compensated for this loss or cajoled into accepting it. Although one can imagine groups being somehow convinced to give up their veto powers in such situations, one expects this to be rare, if the constitutional convention correctly anticipated the relative payoffs from the action when it chose to protect it by invoking the unanimity rule. Rs would nearly always vote down proposed restrictions. Time spent debating and voting on such restrictions would be wasted. Anticipating that most future proposals to restrict this action would lose under the unanimity rule, future decisionmaking costs could be economized by defining a constitutional *right* guaranteeing the freedom to do  $\underline{a}_j$ . This guarantee would prohibit any future political or private actions that infringe on an R's freedom to commit the defined action, or if the analogous condition holds for Cs, on anyone's freedom. Since a right always carries with it the freedom *not* to undertake the action, the community could still try and bribe or persuade a group to refrain from a particular action, and so both outcomes possible under the unanimity rule are still open to the community after it defines a right.

Several features of constitutional rights under this theory are to be noted. First, explicit rights are defined only for actions capable of generating sufficiently strong negative externalities to elicit efforts by some members of the community to restrict the actions. In the absence of possible negative externalities, even actions that provide considerable benefits for the actor will not be challenged and need not be protected. Second, there is an inherent tension between constitutional rights and the principle of majoritarian democracy. When the institutions of explicitly defined rights and the simple majority rule

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are both found in the constitution to deal with situations where individual interests conflict, these situations will differ dramatically in the perceived losses imposed on the different sides from curtailing the action. The simple majority rule is optimal for resolving a negative externality, when an individual at the constitutional stage expects the utility gain from undertaking the action to equal the loss it causes. Rights are defined precisely where the simple majority rule is not optimal, because the expected gains and losses from a ban are dramatically different, and the constitution framers wish to preclude its use. Because rights will be defined only when significant losses are expected for those prevented from acting relative to the losses imposed on others, disputes over rights are likely to be emotionally charged, as they pit a perhaps substantial majority that feels harmed by the action against an intense minority that benefits from it.<sup>16</sup>

A right protects an individual's freedom *to act*. Therefore, all explicitly defined rights contain an *implicit obligation* on all individuals *not* to interfere with an individual who undertakes a constitutionally protected action.<sup>17</sup> *Explicit obligations*, on the other hand, *compel* certain actions. Just as a constitutional right to do  $a_j$  can be thought of as a substitute for a provision requiring that any future restrictions on  $a_j$  imposed by the community be unanimously approved, a constitutionally mandated obligation to do  $a_j$  is a substitute for a provision requiring that all future exemptions to this obligation be unanimously approved. Both need to be defined only in situations of conflict. There is, however, a very important difference between a right and an obligation. A right *allows* an individual the freedom to do  $a_j$ , but does not compel this choice. The individual remains free to do  $a_j$  or not. Thus a right extends and strengthens the blanket freedom to do as one chooses that a constitution should provide.

An explicit obligation compels  $a_j$ . The individual is left no choice. Such compulsion is needed because the actor is made worse off to benefit the rest of the community, i.e., only in a situation of conflict. Thus, an obligation is a form of slavery to the community. One expects, therefore, in communities, where individuals perceive significant gains from allowing people the free-

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16 For further discussion, see MUELLER (1991, 1996a, Ch.14).

17 The word "rights" is often used today in reference to entitlements. Such "economic rights" can also be defended as constitutional provisions by our theory (MUELLER 1991; 1996a, Ch. 16). Here the definition of an action must encompass obtaining needed medical care, an adequate diet, and so on.



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dom to make their own choices, the number of rights *to act* defined in the constitution greatly exceeds the explicit obligations *to act*.

### IX. Summary

Our main results are summarized in Matrix 2.<sup>18</sup>

<i>Matrix 2</i>			
<b>Summary of Cases</b>			
<i>Additional Assumptions</i>	<i>Institutions Placed in Constitution</i>	<i>Treatment of Individuals</i>	<i>Characteristics, Representative works</i>
<i>1. Identity Uncertainty</i>			
None	All constraints and obligations on individual actions placed in constitution No second stage in political process	Symmetric in some cases, asymmetric in others	Constitution maximizes a Benthamite welfare function $w(x) = u_1(x) + u_2(x) + \dots + u_n(x)$ (Harsanyi, 1955, 1978)
<i>2. Identity and Numbers Uncertainty</i>			
2.1 Two groups and binary action choices	2.1. Qualified majority rules governing each action placed in constitution to reveal numbers in each group	2.1. Symmetric in some cases, asymmetric in others	2.1. Maximizes expected utilities

<sup>18</sup> To make the matrix manageable we have left out a few additional assumptions needed in some cases, qualifications, and so on. The reader should consult the relevant parts of the text for more exact descriptions of the cases.

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<p>2.2. Utility gain (loss) to a member of one group from action equals utility loss (gain) caused to member of other group.</p> <p>2.3. Condition 2.1. holds for the actions of both groups, members of each group can be distinguished</p> <p>2.4. Condition 2.1. holds for the actions of both groups, members of two group indistinguishable</p>	<p>2.2. Simple majority rule used to decide action</p> <p>2.3 Simple majority rule used to decide actions of both groups separately</p> <p>2.4. Simple majority rule used to decide actions of both groups</p>	<p>2.3. Outcome is an asymmetric treatment of members of two groups</p> <p>2.4. Symmetric treatment</p>	<p>2.2. Maximizes expected utilities, Rae (1969)</p> <p>2.3. Tyranny of majority is optimal from perspective of all individuals at constitutional stage</p> <p>2.4. <i>May</i> be second best option</p>
<p>2.5. Two groups and continuous action choices</p>	<p>2.5. Qualified majority rules governing each action</p>	<p>2.5.1. Asymmetric in constitution</p> <p>2.5.2. Symmetric in constitution</p>	<p>2.5.1. Tyranny of majority. Outcome does not maximize utility of individuals at constitutional stage</p> <p>2.5.2. Likely second best optimum, Buchanan and Congleton (1998)</p>
<p>2.6. More than two groups</p> <p>2.7. Prisoner's dilemma / allocative efficiency decisions, no decisionmaking costs at post-constitutional stage</p>	<p>2.7. Unanimity rule</p>		<p>2.7. Pareto optimal outcome, but not necessarily one maximizing expected utility at constitutional stage, Wicksell (1896)</p>

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<p>2.8. Prisoner's dilemma / allocative efficiency decisions with decisionmaking costs at post-constitutional stage</p>	<p>2.8. Qualified majority rule</p>		<p>2.8. Maximizes expected utility net of decisionmaking costs, Buchanan and Tullock (1962)</p>
<p>2.9. Single-dimensional conflict issue, symmetric distribution of ideal points</p>	<p>2.9. Simple majority rule</p>		<p>2.9. Maximizes expected utility at constitutional stage</p>
<p>2.10. Single-dimensional conflict issue, positively (negatively) skewed distribution of ideal points</p>	<p>2.10. A qualified majority greater (less) than 0.5</p>		<p>2.10. Exact qualified majority for optimality probably cannot be determined. Its direction from 0.5 can be</p>
<p>2.11. Action gives large utility gain from actor, imposes small utility loss on others. Decisionmaking costs in post-constitutional stage</p>	<p>2.11. Right to act defined in constitution</p>		<p>2.11. A right saves decisionmaking costs over unanimity rule, Mueller (1991)</p>
<p>2.12. Action causes small utility loss to actor, provides very large utility gain for rest of community. Decisionmaking costs in post-constitutional stage</p>	<p>2.12. Obligation to act defined in constitution</p>		<p>2.12. Obligations save decisionmaking costs over unanimity rule</p>

3. Identity, Numbers and Pay-Off Uncertainty

3.1. None	3.1. No institutions can be found which maximize expected utility at constitutional stage		3.1. In general no institutions can optimally be defined in constitution without at least information as to where in Matrix 1 the community is, Rawls (1971)
3.2. Prisoner's dilemma / allocative efficiency decisions, no decisionmaking costs at post-constitutional stage	3.2. Unanimity rule		3.2. Pareto optimal outcome, but not necessarily one maximizing expected utility of at constitutional stage
3.3. Prisoner's dilemma / allocative efficiency decisions, decisionmaking costs at post-constitutional stage	3.3. No qualified majority rule can be chosen unless some assumption is made about utility changes of members of winning and losing coalitions		

a)  $x_i$  is the new allocation of  $x$  to individual  $i$ ,  $s_i$  is the allocation to  $i$  in the status quo.

It is immediately obvious from this matrix that almost all of the interesting cases from the point of our theory fall in the middle range of uncertainty. If participants at the constitutional convention can envisage the utilities of every future individual for every possible future action, and are uncertain only with regard to which of these future individuals they will be, they can write all rules governing future actions into the constitution. Post-constitutional politics disappears, and the constitution maximizes a Benthamite social welfare function. Government will not disappear entirely, because individuals in the post-constitutional stage may have incentives to disobey the stipulations of the constitution, and such cheating must be punished. But,

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no additional collective choices and thus political institutions need be defined.

On the other extreme, if the constitution framers have no idea as to the likely consequences of different actions on future individuals' welfare, they are incapable of writing rules that maximize their expected utilities. The unanimity rule would guarantee Pareto improvements, if decisionmaking costs were zero. But in general, additional normative principles must be invoked to select political institutions for making future collective choices.

In the middle of the matrix, individuals can judge the likely utilities associated with different future actions, but cannot determine the numbers of individuals who will benefit or be harmed by each action; the precise position of each individual's ideal point, etc. In these situations it may be possible to select voting rules to reveal this information in the post-constitutional stage. Our theory allows us to characterize these situations.

### **X. Concluding Arguments in Defense of the Theory**

A fundamental premise regarding democratic government is that it should rest on the consent of the citizens. Since a constitution defines the institutions of government, an ideal way for citizens to express their consent is to agree on the constitution. If we think of the constitution as being written when there is no government – from a state of anarchy – then the process of creating government and writing the constitution is a positive sum game that benefits all citizens by lifting them out of anarchy.

Although the constitution taken as a whole may benefit all citizens, individual elements of it pertain to property rights and other issues of potential conflict, and the resolution of these conflicts could preclude a community's agreeing to the content of the constitution. To avoid this outcome several writers have assumed that individuals at the constitutional stage are uncertain over their future positions.

The two-stage theory of constitutions assumes uncertainty over future positions at the first stage, full knowledge at the second. For those who accept the arguments of Harsanyi (1955) and Rawls (1971) that ethical or just choices should be made by assuming one is uncertain of one's future position, the two-stage theory defines the conditions under which a society *ought* to

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use the simple majority rule, define rights, and so on.<sup>19</sup> Alternatively one might follow Buchanan and Tullock (1962) and emphasize the inherent uncertainty in constitutional choices.

The *weakest* assumption that one could make in a rational actor model of constitutional choice would be that individuals are in full knowledge of their preferences at both stages, and maximize their own utilities. The *strongest* assumption would be that they assume that they are in the original position at both stages. The first assumption does not remove conflicts at the constitutional stage and thus eliminates the possibility of unanimity at this juncture; the second removes all conflicts at all points in time and thus the need for any political institutions beyond the unanimity rule. Assuming that individuals adopt "their ethical preferences" or are moved by moral arguments of the type advanced by Rawls *on at least some* occasions would seem to be a fairly modest departure from normal, rational-actor-model assumptions. Moreover, it seems reasonable to assume that one of these occasions might be the extremely rare event of writing a constitution to govern their and their community's welfare over the indefinite future.

As a factual matter, an assumption that uncertainty would be entirely absent at the constitutional stage is obviously *overly strong*. In a pluralist society, each individual must contemplate the possibility that her faction will lose on some future issues. Some uncertainty about the future consequences of choosing the simple majority rule versus some higher qualified majority rule, the consequences of a right to free speech, etc. must exist at the constitutional stage. Our theory has positive value to the extent such uncertainties would in fact exist.

If those writing a constitution weigh its impact on the welfare of *all* future citizens to some extent, then the institutions included in it should resemble those predicted by our theory. This theory predicts that constitutional protection will be afforded to those actions that generate large expected utility gains for the actors, and may cause small utility losses to others. The actions and freedoms included in the Bill of Rights, added after the Philadelphia Convention to ensure the U.S. Constitution's ratification, do by-and-large have the characteristics suggested by our theory.<sup>20</sup> Each person who voted to ratify the constitution could, conceivably, imagine being arrested, and wished to forbid

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19 For a recent defense of this assumption in the context of a social contract, see BINMORE (1994, pp. 56-61).

20 Articles IX and X are sufficiently vague to make it difficult to discern exactly what actions are being protected.

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"excessive bail,...fines...[and] cruel and unusual punishments" to ensure that his suffering, if arrested, would not be disproportionately large relative to the gains to the community.

The theory serves as a normative justification for those institutions predicted by it, if one believes that a constitution should define institutions that maximize the welfare of all citizens as measured by their utilities. Here, of course, we run into more controversy.

Like all utilitarian theories, ours allows for the possibility that those at the constitutional stage would define institutions that require great sacrifices by some for the benefit of the rest. If a Dr. Faust is willing to sacrifice his own future for current pleasures, a constitutional convention made up of Fausts might well agree to sacrifice some future selves for the pleasures of the remainder. It was to avoid this danger, that Rawls (1971) argued that individuals *ought* to place themselves in an *original position* resembling the bottom of Matrix 2. Denied information about future utilities and probabilities, individuals must resort to other principles to select social institutions.<sup>21</sup>

It is doubtful, however, that Faust, even from behind the veil of ignorance, would be persuaded by Rawls to ignore and therefore sacrifice the future pleasures of nearly all members of society for the benefit of the worst off person, as Rawls's second principle of justice would demand that he do. A contract, social or constitutional, can be only as good as the people who write it. Although it is *possible* to imagine a community of individuals agreeing to impose great sacrifices on some for the good of the others after weighing the utility gains and losses to both groups, it is neither *inevitable* nor *likely* that they would do so. Slavery is often offered as an example of the kind of morally objectionable institution that utilitarianism could condone. But slavery has precisely the characteristics that would from our theory lead us to anticipate a constitutional ban against it – large expected utility losses for those prevented from acting, and relatively small gains from those benefiting from slavery. The original failure of the U.S. Constitution to ban slavery was not due to a willingness of its ratifiers to accept a fair gamble on being a slave in the future, but rather to the fact that the white males who ratified it knew that there was no chance of their ever being slaves. It seems highly unlikely that any constitution written today would allow slavery, *if* the individuals who wrote it actually contemplated the sacrifices that would be imposed on the

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21 See also the arguments of AMARTYA SEN (1977, 1979, 1996) against "welfarism" in his work on liberal rights.

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slaves and the benefits to the rest of the community. Nor do I think that the U.S. Constitution would have allowed slavery, *if* the individuals who wrote it, valuing freedom and liberty as they did, had engaged in this mental experiment, as they did when contemplating arbitrary arrest. By giving weight to the utility loss of every individual from a restriction on his or her freedom to act, our theory justifies constitutional protection for these freedoms in any community where citizens derive considerable utility from their exercise.

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## 13 The Constitutional Stage Revisited<sup>1</sup>

ANTÓNIO S. PINTO BARBOSA

In a short article written in 1964 in celebration of the sixtieth birthday of Professor A.P. Lerner, Paul Samuelson criticized the notion of the 'veil of ignorance' used in the *Economics of Control*.<sup>2</sup> Lerner (1944) advanced such concept to derive the strong proposition according to which in society

"the ... probable value of total satisfactions is maximized by dividing income *evenly*."

Samuelson's point of contention, however, was not directed at the egalitarian result as such but at the use of the very notion of equal ignorance from which it was ultimately derived. Specifically, he argued:

"If I have a beautiful singing voice, a pretty face, a high I.Q., an inherited title, or the gift of salesmanship, I shall be stupid to think that the egalitarian state is the safest hedged state *for me*. I don't expect the inegalitarian state to deal me a random selection of the cards. My ignorance is balanced around a favourable deal and I shall certainly not make the vote unanimous even if I have concave utility."(p. 176)

This quotation raises an important question in the area of constitutional economics. In fact, one can ask: What kind of motivation might persuade a rational individual, who happens to know, here and today, his own specific position in the social setting, to admit embarking on the choice of income distribution under the veil of ignorance? That is, even if we abstract from such complications as how to operationally generate the 'veil of ignorance', some rationale seems to be required to justify a preference for such choice-setting in the first place.

Amidst many other outstanding contributions to the foundation and development of constitutional economics, I think we owe, here again, to Buchanan a decisive contribution to the clarification of such central question. As

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1 I would like to thank the comments on an earlier version received from Vasco Santos, Mario Pascoa, Paulo Barcia, Duarte Brito and Pedro P. Barros.

2 The term 'veil of ignorance' was due, of course, to RAWLS (1972).

I have been, at some earlier point, similarly interested and intrigued by Samuelson's objection to the notion of the veil of ignorance, I thought that James Buchanan's 80th birthday would be an excellent occasion to briefly revisit this topic.

For that purpose I take a most simple description of a constitutional decision on the division of social income under the veil of ignorance. I assume two individuals, *A* and *B*, who have to choose how to allocate a fixed social income, *Y*, normalized for convenience to unity, between two positions, according to shares  $\theta$  and  $1-\theta$ , ( $0 < \theta < 1$ ). For simplicity, suppose that both individuals possess the same strictly concave utility function of income,  $U(Y_i)$ ,  $i = A, B$ . Consider now the viewpoint of one of these individuals, say *A*, under a generalized notion of the veil of ignorance. Specifically, assume that *A* has to choose optimal  $\theta$  so as to maximize his expected utility as given by

$$S(p_1, p_2, \theta) = p_1 U(\theta) + p_2 U(1-\theta), \quad (1)$$

where  $p_1$  and  $p_2 = 1 - p_1$  indicate the probability *A* subjectively assigns to the occupation of the two alternative positions. Under complete ignorance (the 'equal ignorance' case analysed by Lerner and Samuelson) it would be appropriate to assume an equal probability of occupation of the two possible positions:

$$p_1 = p_2 = 1/2. \quad (2)$$

However, expression (2) might simply represent a limiting case of a generalized notion of the veil of ignorance. In fact, one can envisage a continuum of situations where, at one extreme, *A* knows with certainty his social position, say, the position he currently holds,  $p_1=1$ ,  $p_2 = 0$ .<sup>3</sup> Under Samuelson's terminology he knows whether he possesses a beautiful singing voice, a pretty face or a high I.Q. From this extreme, as uncertainty increases, one can assume that  $p_1$  declines monotonically ( $p_2$  increases) until the 'equal ignorance' limiting situation (2) is eventually attained. Suppose, therefore, that this variable degree of uncertainty is represented by  $t$ , so that  $p_1 = p_1(t)$ ,  $p_2 = p_2(t)$  and

$$p_1(0) = 1, dp_1/dt < 0, \lim_{t \rightarrow M} p_1(t) = 1/2, \quad (3)$$

where  $M$  corresponds to some limiting situation of complete uncertainty in which Lerner's 'equal ignorance' prevails. One possible descriptive interpretation of the index  $t$  is the following: it might represent the time interval be-

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3 A symmetric reasoning is assumed for *B*.

## THE CONSTITUTIONAL STAGE REVISITED

tween some initial moment where, under the veil of ignorance,  $A$  chooses  $\theta$  (the constitutional stage) and a subsequent moment where, under individual knowledge of the specific social positions occupied, a lagged implementation of that distributive choice takes place.<sup>4</sup>

Taking a given degree of uncertainty, i.e. a specific value for  $t$ , under this generalized notion of the veil of ignorance, there is some optimal  $\theta$  from the standpoint of  $A$ , call it  $\theta^*(t)$ .<sup>5</sup> Except for the limiting case of an equal probability of occupation,  $B$  would most likely find a different value for his optimal  $\theta$ . To obtain a collective decision, some bargaining and possibly some compromise between  $A$  and  $B$  seems, therefore, required.

Under the most favorable circumstances for  $A$ , in which his optimal solution would prevail as the constitutional collective choice, the corresponding expected value for  $A$  may be represented by

$$S^*(t) = S[p_1(t), p_2(t), \theta^*(t)]. \quad (5)$$

As indicated, this value is dependent on the degree of uncertainty,  $t$ , which was assumed exogenously given.

Now, it can be shown that  $S^*$  declines uniformly as the degree of uncertainty increases, thus indicating that, from the standpoint of  $A$ , the amount obtainable under the most favorable circumstances diminishes. From his standpoint the game seems to become, so to speak, increasingly uninteresting. This is perhaps not too surprising a result in view of the fact that the veil of ignorance contributes to a sort of depersonalization, rendering  $A$  in the limit formally indistinguishable from  $B$ . In view of the anticipated decline of expected utility, one may therefore ask what kind of motivation might induce  $A$ , if he has to choose  $t$ , to prefer a choice setting involving increased uncertainty? In other words, since one would not expect the inegalitarian state, as Samuelson puts it, 'to deal ... a random selection of the cards', what kind of logic might favour such solution?

To rationalize the potential emergence of individual interest in the use of the veil of ignorance as a decision-making framework some element seems, therefore, to be missing in the foregoing analysis. This critical element has, in

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4 I ignore here discounting. I recall at this point the particular instance of lagged implementation of the Rignano tax plan in Italy suggested by BUCHANAN (1967, p. 299). Elsewhere (BARBOSA 1978) I have used the term *vacatio legis* to describe this same time interval.

5 Under this simple framework,  $\theta^*(t)$  would have to satisfy (4)  $U[\theta^*(t)]/U[1-\theta^*(t)] = p_2(t)/p_1(t)$ .

my interpretation, been advanced by Buchanan when he demonstrated the central role played by decision-making costs savings as a result of increased uncertainty.<sup>6</sup> These bargaining costs savings, in turn, stem from the fact that the veil of ignorance tends to render the separate individual choices at the constitutional stage more similar to each other.

"The inherent uncertainty in choice among rules makes consensus among separate players much more likely to be attained than might otherwise be expected" (Buchanan, (1967), p.218.)

The individuals become more agreeable and unanimity may even be attained in the limiting situation of 'equal ignorance'. In other words, the above analysis is, so far, incomplete since it does not take into account the absorption of resources associated with decision-making. To allow for this factor suppose decision-making costs,  $C$ , take the following simple form:

$$\begin{aligned} C(t) &= c\beta^{-t}, 0 \leq t < M, \\ &= c\beta^{-M}, t \geq M. \end{aligned} \quad (6)$$

where  $\beta > 1$  and  $0 < c < 1$ . We thus assume that decision-making costs decline as uncertainty increases. When there is no uncertainty, ( $t = 0$ ), decision-making costs attain a maximum fraction of total social income,  $c$  ( $0 < c < 1$ ). As the degree of uncertainty associated to the occupation of social positions increases,  $C$  declines (monotonically) approaching a minimum value under 'equal ignorance' ( $t \geq M$ ). With this specification, the net amount of social income available for distribution is

$$1 - c\beta^{-t}. \quad (7)$$

Assuming that the distributive shares  $\theta$  and  $1 - \theta$ , to be constitutionally chosen, apply to this net income, the expected utility  $A$  obtains, given  $t$ , is now modified to<sup>7</sup>

$$S(p, p, \theta) = p_1 U[\theta(1 - c\beta^{-t})] + p_2 U[(1 - \theta)(1 - c\beta^{-t})] \quad (8)$$

Let  $\theta^{**}$  indicate  $A$ 's optimal choice of  $\theta$  under these circumstances and let  $S^{**}$  indicate the corresponding expected value he obtains when such choice prevails. It is now possible, though by no means certain, that this ex-

6 See, for instance, BUCHANAN (1967), Ch. 14 and 19, and BUCHANAN AND TULLOCK (1962), Ch. 13.

7 For simplicity, we are assuming that the decision-making costs depend only on  $t$  and not on  $\theta$ .

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pected value might increase with  $t$ . This suggests that the prospect of solving the distributive question through constitutional means is, in such a case, well grounded in individual motivation. The random selection of cards, to use Samuelson's words, seems to be in accordance with individual interest. If the costs of decision-making are significant ( $c$  large) and decline rapidly with increased uncertainty ( $\beta$  large) that possibility might happen, as illustrated in the diagram below, where  $S^{**}$  is plotted against the degree of uncertainty at the constitutional stage.

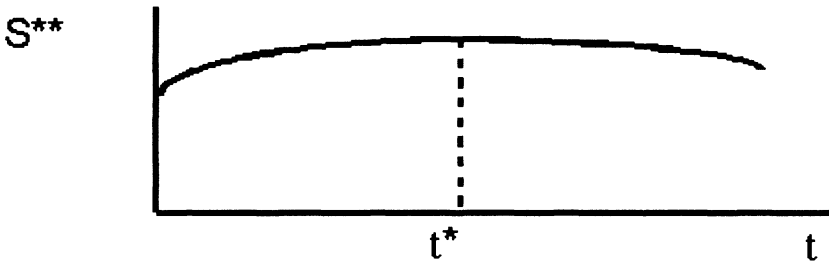


Figure 1: Expected value of  $A$ 's most-preferred choice.

The diagram also indicates the value  $t^*$  corresponding to the maximum expected value for the constitutional prospect. Under the interpretation suggested above for  $t$ ,  $t^*$  might represent the optimal lag, from  $A$ 's standpoint, between decision and implementation of the distributive choice.

We might conclude by stressing again that some element seems to be often missing in the analysis of the individual choice calculus at the constitutional stage. This analysis typically highlights the redistributive ethical properties potentially associated with decisions taken in that framework. However, when the adoption of such framework is to be based on efficiency grounds, it is necessary to justify how optimizing individuals might find in their own interest to choose under a veil of ignorance. This motivational element seems needed the more so since the expected value of individual most-preferred choices declines with increased uncertainty under the veil of ignorance. The critical missing element is the decision-making costs savings obtainable at the constitutional stage. The recognition of its central role represents, in my view, one of the fundamental contributions Buchanan brought to the area of Constitutional Economics.

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# 14 Evolution and Learning in Collective Decision Making

JOSE CASAS-PARDO / JUAN D. MONTORO-PONS /  
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- I. Introduction
- II. Modeling Learning in Decision Making in a Political Economy
  - 1. A Basic Model of Learning
  - 2. From Learning to Evolution
- III. Results from Computational Experiments
  - 1. Applying the Median Voter Theorem
  - 2. A Representative Democracy with Political Parties
  - 3. The Vote Motive
- IV. Discussion and Conclusions

**Abstract.** Since its initial developments in the 60's, the intellectual contributions of James Buchanan have influenced the research of scholars working in the field of politics and economics. On his eightieth birthday we want to contribute to the *Buchanan festschrift* with this paper. In it, we develop a model of social interaction among individuals in the political market. We depart from the standard economic hypothesis by assuming a bounded individual rationality. The evolutionary character of the model is based on the process by which individuals take their political decisions: it tries to link decisions and outcomes through a learning process. To this extent we use concepts from the cognitive sciences and try to apply them, with varying degrees of success, to public choice.

## I. Introduction

The influence of James M. Buchanan's contributions to political economy have led to an ongoing and fruitful research program. Part of it has been

focused on the process by which individuals coordinate leading to a given social order within a contractarian approach. The ultimate goal of this work is a particular form of social cooperation that may shape the institutions of an economy, namely the social order of a free society the ultimate goal of this work. In this respect, as Yeager (1990) and Baird (1989) point out, Buchanan's work has some common points with Austrian economics.<sup>1</sup> We need not elaborate on these common points as they will be familiar to readers: knowledge, discovery and disequilibrium, and of course subjectivism are some common aspects of a non-orthodox way of understanding social phenomena. Much of this view can be characterized by the exchange paradigm. Exchange implies a continuous process of interaction among individuals that leads to an accumulation and spread of knowledge and to the evolution of the social systems. This approach differs from the systematic application of restricted maximization to social problems.

Following this paradigm, this paper addresses to the learning process of individuals in the political market. We are interested in evolution and the disequilibrium properties of the exchange that takes place in the collective action. To this end we will resort to experimental simulation of a very simplified model of an economy. In doing so, we characterize individuals by their learning capabilities rather than by an extremely demanding concept of rationality. The paper is structured as follows: the next section discusses the theoretical framework; then the results of some experiments are shown; the final section is devoted to discussion and conclusions.

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1 However there are also some points of conflict: in his *Limits of Liberty* (BUCHANAN 1975), Buchanan poses his concerns about the limits of evolution. His criticism to the *Hayekian* concept and its applicability to social institutions casts no doubts about his lack of enthusiasm for a social organization based upon such a concept. Anyhow it must be noted that his critique is directed towards the efficiency properties of evolution. Although we develop an evolutionary model of political decision making, it does not embody the evolution of political institutions, that we consider given.

## II. Modeling Learning in Decision Making in a Political Economy

We start this section by briefly describing the model on which the computer simulations were based. The outcomes of the model are the result of individual decisions in the collective realm. The basic setup as well as the learning process is partly based on a model by Lettau and Uhlig (1999), but generalized for a context of collective decision making with  $N$  agents. In this, individuals identify the state of nature that in the model is given by the level of income. Taking this as a data, and analyzing past options and their influence on future states, individuals take next action as the result of evaluating their political options. A political option of an individual is a mapping from the set of states to the set of decisions. In this paper we are concerned with the evaluation of political options and the weak link between individual decisions and the outcomes of political processes, a question that Buchanan and Tullock (1962) already stressed as a limit to individual rationality in the public sphere.

### 1. A Basic Model of Learning

Assume an economy with  $N$  individuals. For our purposes we will consider a stationary population interacting during  $T$  periods. The main features of the model are:

1. At the beginning of each period  $t$ , every individual  $i$  is endowed with an amount of resources that will be denoted as  $y_t^i$ , and can be considered as period  $t$  income. Endowments follow a *Markov chain* with  $m$  different states, although for simplicity we assume  $m=2$ , leading to two possible situations for an individual: high income ( $\bar{y}$ ) and low income( $\underline{y}$ ). The probability of transition from state  $i$  to state  $j$ , given  $i \neq j$ , is:

$$p_{ij} = \begin{cases} \frac{(1-\rho)}{2} & \text{if } i \neq j \\ p + \frac{(1-\rho)}{2} & \text{if } i = j \end{cases} \quad (1)$$

where  $\rho$  plays the role of an autocorrelation term. The closer it is to one, the higher the probability of remaining at the same state. In this way we

ensure an autoregression in the process. In addition, while being at one state, income follows a random walk:

$$y_t^i = y_{t-1}^i + e_t^i \quad (2)$$

where  $e_t^i$  follows a NID(0,σ). This representation allows for a dynamic evolution of the income with a stochastic trend.

2. Individuals derive utility from consumption. Thus in a world without a public sector, and ruling out intertemporal transfers of income by means of wealth accumulation, an efficient allocation is one in which all income is consumed. Let  $q_t^i$  be the quantity of private good consumed. Then the utility of individual  $i$  is given by  $u(q_t^i) = u(y_t^i)$ .<sup>2</sup>
3. As our work addresses the allocation of resources between private activities and public ones, the next step is to include a public choice mechanism. After income has been determined, collective decision takes place. At that stage individuals vote for a political program. Two alternatives were considered for simulation purposes:
  - A situation in which individuals vote for a redistribution level. In this case, the net utility is derived as initial income plus (minus) the transfers from (towards) the public sector.
  - A situation in which individuals vote for the public supply of a quantity  $Q$  of a pure public good. Now individuals include another argument in the utility function, i.e. the total amount of public good provided ( $u(q_t^i, Q_t)$ ).

In both cases individuals choose a proportional tax system. We have considered two main scenarios for public choice to take place: One in which applying the majority rule, the median voter determines the outcome of the process; another in which individuals vote for political parties. Restrictions to the maximum level of redistribution/public good supply, as well as the decision making rules are considered to be constitutionally fixed.

4. Once the amount of redistribution or public good supply has been chosen in the political process, an individual evaluates the fitness or strength of her political option. In doing so, she considers the utility from consump-

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<sup>2</sup> We used two utility functions in our model: a logarithmic transformation of a Cobb-Douglas function, and a CRRA function.

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tion, the state of the world and the state of her decision. The fitness of an option has to account for the fact that there may be no direct link between an individual's choice and the political outcome. Additionally, as there may be resources invested in gathering information, voting may be costly. Both aspects will be considered. Finally, by ordering strengths, individuals rank political options. That ranking will help in the next collective decision making stage.

The process of evaluating and updating the fitness of political options is an evolutionary one. Learning which options are most fitted for a given state is the main feature of this process. The mechanism by which learning takes place is briefly discussed next.

### 2. From Learning to Evolution

The main point of this paper is that political decisions taken by individuals are the result of evolution and learning. This need not exclude rational behavior, as it is also possible to learn to be rational. However, not all decisions will be rational in the economic sense of the word, but may be rational in a broader sense. Given the set of all the possible states of nature, a political option<sup>3</sup> is to be understood as a mapping from a given state into an action or decision. The most basic action in a public choice setting is voting. To take a political option and vote accordingly implies considering the implications of that decision. To some extent whenever individuals are in the public domain their decisions are affected by decisions they took in the past and by the outcomes of political processes. This simple idea may be formally developed by using the concept of a *classifier system*.

We will begin with the intuition behind it. Given an state (in our example high income/low income) an individual has to decide the allocation of her resources between private or public consumption.<sup>4</sup> The effect of a private decision is the utility of consumption. Public decisions are converted into political outcomes through the political process; these may affect the utility of individuals either increasing or decreasing it. Define the *fitness* of a

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3 A political option in public choice is the counterpart of a rule in the private realm. Although they have the same meaning, in collective decisions individuals follow options rather than rules.

4 As there are differences between redistribution and public good consumption, in this example we consider a negative income tax schedule.

political option as an ordinal value that the individual assigns to an action given a state. Define a classifier as the pair of an option with its related fitness. Then a classifier system is the set of all possible pairs {option, fitness}.

The problem we are considering can be stated in the following terms: given a state of nature, an individual has to choose a political option. The logic underlying the actual setup is that an individual will choose the option which is most fitted with the actual state. The fitness of an option in a classifier system is given by the utility of the individual and the state it induces. Hence there is a discounting of the effects of an option in the future.

The obvious question is how an individual links an option with its fitness. As the outcomes of political processes may be weakly related to the option an individual took, there may be no way in which an individual updates the utility derived from a political situation. This is in fact the main problem that we faced in our example but we tried to solve in a simple way. We will illustrate this with an example.

Consider the median voter of a political process in which decisions are taken by using majority rule. In this case her options will be the winning ones. This means that there will be a direct link between option and political outcomes. In this case the updated fitness of option  $k$ , that was taken at period  $t-1$ , in period  $t$  will be:

$$\Delta r_t^k = f(r_t^j, r_{t-1}^k, u(q_{t-1})) \quad (3)$$

Expression (3) updates the fitness of an option by using the discounted fitness of the option that it may induce in  $t$ ,  $r_t^j$ , the utility of that option  $u(q_{t-1})$  (now as we are in the median voter case this utility points towards the political process), and its own fitness.<sup>5</sup>

However not all individuals are the median voter and not all political decisions use the majority rule. This means that options may not be translated into individually desirable outcomes. For this case an alternative updating function is proposed in which the outcome in  $t$  is taken into account:

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5 Expression  $f()$  in equations (3), (4) and (5) may be interpreted as a dynamic error correcting mechanism. It is usual to find this term as a convergent sequence over time by adding a decreasing sequence. This diminishes the weight of the correction term over time. In our simulations we employed the sequence:

$$\omega \frac{1}{t} f()$$

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$$\Delta r_i^k = f(r_i^j, r_i^{j-1}, r_{i-1}^k, u(q_{t-1})) \quad (4)$$

Here option  $i$  refers to the outcome of the political process, and option  $k$  to the chosen option which need not coincide. Finally equation (4) can be generalized to include the cost of political decision making. If we assumed that there are costs in the act of voting then we have expression (5):

$$\Delta r_i^k = f(r_i^j, r_i^{j-1}, r_{i-1}^k, u(q_{t-1}), c_{t-1}) \quad (5)$$

where  $c_{t-1}$  represents the disutility from voting. In this last expression  $c$  amounts not only to the resources allocated in the political decision making process, but also for the gap between political option and outcomes.

To summarize, individuals evaluate their political options (and their related decisions) in terms of their relative fitness for a given state. This fitness is evaluated and updated according to past information but also discounts, although in a limited way, the future. It is from this evolutionary process that political outcomes emerge. In the next section we will draw the conclusions from different computational experiments.

### III. Results from Computational Experiments

Three different simulation experiments were conducted by using the basic model described in the previous section. To this end we simulated a political economy with a stationary population of  $N=1000$  individuals. These individuals interacted during  $T=1000$  time periods. At the beginning of each interaction the endowment of each individual was fixed, and hence the state, according to expressions (1) and (2). With respect to income there are two additional facts to be considered. First, the ratio between high income/low income has been considered fixed and equal to 4. Second, in order to seed the initial population we set parameter  $P_0$ , which is the probability of being in the low income group at  $t=0$ . Both data will appear in most of the results table.

Then, political decisions are taken among the different available alternatives. To this end, three different political scenarios were considered. The first one describes a political process in which decisions are directly taken by a simple majority rule; this leads to the well known median voter theorem results. The second one considers a representative democracy in which three parties offering three different programs compete for votes. In this case the

winning party defines the political action to be taken. Finally, the third one is a generalization of the previous one which includes the option of non-participation in the political process.

Individuals vote for a proportional tax rate  $t_j^i$ . Given individual options and a political setting, the outcome of the process is  $t^*$ . The total amount of taxes raised,  $t^* \sum y_i^i$ , will be collectively used either for providing a quantity  $Q_i$  of public good, or for redistributive purposes. In the former case all individuals in the economy equally benefit from the consumption of the public good. In the latter case a negative income tax (NIT) system is proposed, such that:

$$T_i^i = -S + t^* y_i^i \quad (6)$$

being  $S=Q/N$ . Once political options are evaluated and decisions emerge, and the political outcome is known, voters update their classifier systems and the process begins again.

### 1. Applying the Median Voter Theorem

In this section we discuss the main simulation results of the model considering that:

- voters are distributed along a line of political options;
- decisions are taken by means of majority rule.

This leads to a direct application of the median voter theorem and its well known results. Tax rates are restricted to be in the range  $[0.0,0.7]$ . Table 1 presents the main results when the outcome of collective action is the provision of a public good. Table 2 shows these results in the NIT case. Both show very similar outcomes for different initial probabilities of being in a *low income* state  $P_0$ . Outcomes are the average of 1000 runs of the program.

It can be seen that the amount of redistribution/public good provision is located in all cases in a central range of the tax spectrum. Whenever this tax spectrum was modified the results were modified consistently.<sup>6</sup> Finally the population was almost equally distributed around the median result for different population compositions.

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<sup>6</sup> In fact we run a simulation with a narrower range of tax rates (0.0-0.3). Median results ranged from 0.13-1.166; these support our conclusions.



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Table 1: Provision of a pure public good. The median voter theorem case.

$P_0$	$\rho$	Range of $t^*$		Fraction of voters	
				Below $t^*$	Above $t^*$
0.50	0.95	0.3818	0.3111	0.4335	0.5245
0.75	0.95	0.3888	0.3181	0.4506	0.5493
0.25	0.95	0.3959	0.3181	0.4474	0.5609
0.50	0.50	0.3888	0.3111	0.4337	0.5444

Table 2: Redistribution through a NIT. The median voter theorem case.

$P_0$	$\rho$	Range of $t^*$		Fraction of voters	
				Below $t^*$	Above $t^*$
0.50	0.95	0.3888	0.3252	0.4530	0.5567
0.75	0.95	0.3818	0.3181	0.4518	0.5272
0.25	0.95	0.3818	0.3181	0.4452	0.5328
0.50	0.50	0.3818	0.3252	0.4524	0.5334

### 2. A Representative Democracy with Political Parties

Consider now a representative democracy with three different political parties: R, C and L. R offers a low level of public redistribution; C offers a higher collectivization of private income; finally L offers the highest level. For simulation purposes we set the tax rate of each party as 0.1, 0.35 and 0.65 respectively. Now, individuals cast their votes for a party, and the winner decides the policy.<sup>7</sup>

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<sup>7</sup> This could be the case of many European representative democracies, where the majority of a parliament need not be supported by a majority of the votes of the population. For example in Spain the representation system tries to favor parties with a higher number of votes in order to reduce fragmentation.

Table 3: Redistribution through a NIT. Choosing among three options

$P_0$	$\rho$	Fraction of wins		
		R	L	C
0.50	0.95	0.1901	0.2252	0.5845
0.85	0.95	0.2302	0.5025	0.2672
0.15	0.95	0.3111	0.3493	0.3393
0.50	0.50	0.2032	0.4714	0.3253

Table 4: Provision of a pure public good. Choosing among three options

$P_0$	$\rho$	Fraction of wins		
		R	L	C
0.50	0.95	0.2252	0.2832	0.4914
0.85	0.95	0.5475	0.2572	0.1951
0.15	0.95	0.0610	0.6256	0.3133
0.50	0.50	0.3773	0.2012	0.4214

Table 3 and 4 show the results of these simulations. Again outcomes are an average of the total number of simulations, so they will give a rough view of the evolution of the process. If we focus on the redistribution case, table 3, it seems that the initial income distribution of the population matters. The first row of the table shows the situation in which low income individuals are approximately half the population. In this case, chances are that a high redistribution of income may be a fitted option for that half of the population; the ordering of the three programs point to this fact. However if the proportion of low income individuals is over 50% (for example an 85%, in the second row), redistribution will tend to be lower, as there will be low income individuals which may not benefit from this redistributive process. The same conclusion, but for the opposite reason, is drawn when only 15% of the initial population belongs to the low income individuals. Finally, the fourth row shows the case in which  $\rho=0.5$ . This means that there is a 50% probability that an individual changes from one state to another. A moderate result is the outcome of this simulation. This shows how individuals do, partially, learn from past experiences: they can be either net contributors or receivers of the tax system.

If we change to the provision of a public good (see table 4), most results of the previous experiment hold. However these cannot be interpreted in the same way. As long as now all individuals are net receivers of the public

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good, there should be a trend towards more extreme results. Experimental results do not support this point, due to individual bounded rationality.

### 3. The Vote Motive

One of the most controversial issues in public choice has been on the rationale of voting. As the expected effect of an individual vote is marginal, and as the costs of being rationally informed surpass the benefits, there are no rational motives for voting. However empirical data show that in real world democracies many people vote; in this case they may not be taking rational decisions.

In order to analyze the possibility of non-participation (A), we have conducted a third simulation in which the act of voting was costly. Table 5 shows the results. In these, we considered both  $\rho=0.95$  and  $P_{\sigma}=0.5$  fixed. The cost of voting was introduced in three different ways.

1. First, as a fixed proportion of income. In this case two additional options were considered: voting is costly (I), and voting to a non winning program is costly (II). In both cases results show that the number of abstentions was on average over one quarter of the population. Figure 1 shows the evolution of 20 iterations of the population. It can be seen that the levels of non-participation may be significantly over the average, and that the three options are quite close. However the L program wins almost one out of two elections.
2. Second, as a fixed cost. Again two options (voting is costly, I, and voting to a non winning program is costly, II) were introduced. Results show that option I is consistent with the previous results. However option II gave a higher percentage of L wins. In the former, levels of non-participation were significantly above the previous results.
3. Finally, it was considered that the results of public action may be distributed among the voters of a program. This is what we have called private appropriation of public programs.<sup>8</sup> By this we mean that the beneficiaries of public programs are the voters of the party. In this case the cost of voting is introduced via the opportunity cost of not being in the winning party. Results are quite appealing, and the first 20 iterations may be seen in figure 2. Obviously individuals learn quickly and vote for the winning option (L). While most of them could be better off by voting a moderate

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<sup>8</sup> In the table appears as appropriation.

alternative, approximately the 50% of the population, if they are not in a winning coalition, they will incur in higher costs. This leads to a kind of social dilemma. According to these results abstention falls to a low 5% of the population, proving that individuals are not rational but they try learn how to be.

If we ignore the conclusions drawn from the third option, the introduction of the cost of voting in a evolutionary model of a political process, leads to a middle point between public choice and political science. Individuals do vote more often than public choice predicts, but less often than political science considers they should. This may in part be explained by one reason: an individual effect on the final outcome of a collective decision is directly related to the degree of participation. If it is high, her probability of affecting the outcomes decrease. And conversely it increases for lower participation. Figure 1 shows this. The cycling in non-participation may be partly due to the process of discovering the varying marginal effect of individuals in elections.

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Table 5: Redistribution through a NIT. Introducing the cost of voting

Costs	Fraction of wins			
	R	C	L	A
Proportional to income I	0.2252	0.2832	0.4914	0.2883
Proportional to income II	0.2612	0.3213	0.4174	0.2501
Fixed cost I	0.2342	0.3543	0.4114	0.4602
Fixed cost II	0.2252	0.0860	0.6886	0.2562
Appropriation of public programs	0.0000	0.0000	1.0000	0.0567

Figure 1: Dynamic evolution of votes and abstentions with a proportional cost of voting

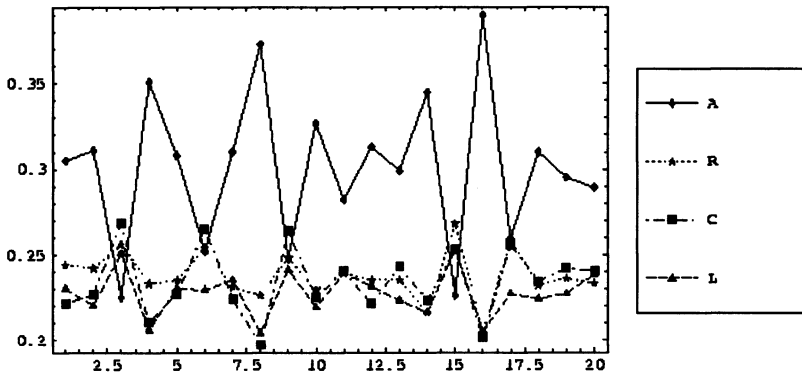
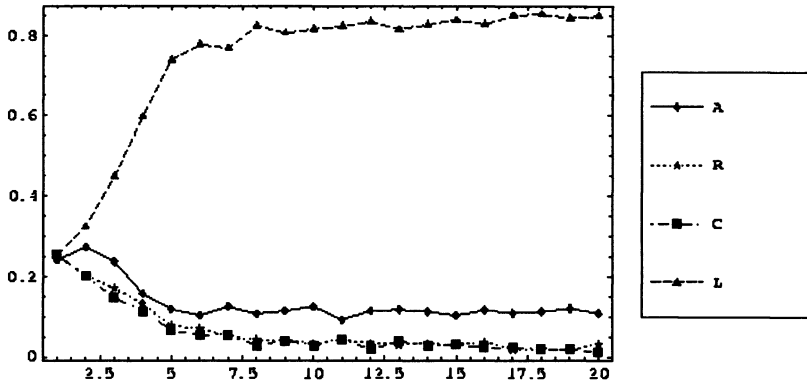


Figure 2: Dynamic evolution of votes and abstentions when public benefits are privately appropriated.



#### IV. Discussion and Conclusions

The previous pages showed the results on the simulation of a very simplified experimental political economy. This way of modeling differs in a significant way from orthodox economic theory where rational individuals interact maximizing some well defined objective function. However if the standard approach is of limited scope in economics, it has more drawbacks in the political exchange where the means and objectives of individuals are fuzzily defined. Moreover, individuals do not possess an invariable view of the real world but it changes over time as they learn from situations they experienced and revise their previous views.

The evolutionary approach, while keeping some features of the orthodox models, give more insights into the questions related to public choice and specifically collective decision making. While *irrational* social outcomes may arise from rational individuals, it is more likely that these have the origin in a limited concept of rationality. Individuals need not compute all the information an economist will suppose them to do, but just a limited set. Public choice has referred to this question as the *rational ignorance*, establishing a link between public choice and the evolutionary literature. Using this setup individuals may try to adapt and learn to the environment, perhaps searching

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for an optimum, but without explicitly optimizing. They just compile past information and return their actions as a direct consequence of this process. To some extent this is to suppose that individuals have different representations of the world (for our purposes the world is limited to the political process) that depend on their initial information endowments (that in our model were randomly generated), the situations and states they face, and the relation between decisions and outcomes. This implies that even "rational" choices will be different for different individuals<sup>9</sup>; then, why should limited rational behavior define a clear pattern?

Simulations yield some interesting results:

- Constitutional restrictions do matter: the rule for making decisions, or the degree of collectivization, to mention two of the experiments, affects the outcome of the political process.
- We do not have to assume instrumental rationality to get rational results. When running the experiment on privatizing the benefits of public action, it was clear that almost all individuals vote for the L program. Better be with them! If the social dilemma may be reproduced in experiments, this may help in detecting the origins and/or the solutions.
- However not all actions mimic rational behavior. In our setting, the degree of public provision of a pure public good was below the optimal level. In this case individuals did not achieved the standard of rationality that the neoclassical theory would suggest.

To conclude, it is not clear whether a collective decision making process may be better depicted by this kind of model or by a neoclassical setting. In any case it is a question under research that cannot be answered, at least in a definitive way, at this stage.

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<sup>9</sup> As NORTH (1993) puts it, in a rational environment restrictions are unnecessary.

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# 15 Revisiting "The Nobel Lie": An Argument for Constitutional Constraints

JEFF R. CLARK AND DWIGHT R. LEE

- I. Introduction
- II. Expressive Voting and Government Exploitation
- III. Subverting the Public Trust
- IV. Some Additional Implications
- V. The Case for Constitutional Constraints
- VI. Conclusion – Is Trust Incompatible with Trustworthy?

## I. Introduction

For the public sector to function at all, there must be some degree of public trust in its ability to function and achieve the goals for which it was established. As early as the 1700s Benjamin Franklin pointed out that "Much of the strength and efficiency of any government, in procuring & securing happiness to the people, depends on . . . the general opinion of the goodness of that government."<sup>1</sup> In 1988 Buchanan and Brennan argued that the basic public choice premise that government action is motivated primarily by private interest, might well serve to undermine public trust in government and reduce its effectiveness. In concluding their argument they posed a key question, "Is public choice immoral?" and responded that (1988, p. 184):

Even if the explanatory power of public choice models of politics is acknowledged, the moral spillovers of such models on the behavior of political actors may be deemed to be so important as to negate any purely "scientific" advance made in our understanding of how politics actually works. The maintenance of the standards of public life, it could be argued, may require a heroic vision of the "statesman" or "public servant," because

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<sup>1</sup> Quoted in SAMUELSON (1995), p. 187.

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only by holding such a vision can the possibility of public-interested behavior on the part of political agents be increased.

More recently, scholars from across the ideological spectrum have expressed concern that a decline in public trust can undermine government's ability to perform essential tasks. Joseph Nye (1997, p. 4), Dean of Harvard's Kennedy School of Government, with at least moderately liberal leanings, argues, "If people believe that government is incompetent and cannot be trusted, they are less likely to provide [critical] resources. Without [these] resources, government can't perform well, . . ." Conservatives William Bennett and John DiIulio, Jr. have cautioned against what they see as the public's "delegitimizing the idea of government."<sup>2</sup>

Public trust in government has been declining since the 1960s, and concern over this decline has been increasing. Data from University of Michigan polling, that began in 1958, show trust in government peaking around 1964, when about 75 percent of the respondents answered "always" or "most of the time" to the question, "How much of the time do you think you can trust the government in Washington, to do what is right—just about always, most of the time, or only some of the time?" Since that time, trust has declined significantly (though not monotonically) with only about 25 percent answering "always" or "most of the time" in 1994.<sup>3</sup> Numerous organizations and scholars see this decline in public trust as a threat to the proper functioning of our political democracy. A brief search of the Internet turns up twenty - thirty websites devoted to the issue.<sup>4</sup> Major studies centering on the issue have been recently carried out by the John F. Kennedy School of Government, the University of Virginia, and The Pew Research Center for the People and the Press.<sup>5</sup>

The arguments offered by Franklin, Brennan and Buchanan, Bennett, and DiIulio, and Nye, that government performance is positively influenced by public confidence is certainly plausible, but just as plausible, though commonly overlooked, is that confidence in government is something that gov-

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2 Quoted in SCHLESINGER (1998).

3 See Figure 3-1, ORREN (1997), p. 81. There is some evidence that the hostility toward government has declined some since 1994, but the long-run trend in the public attitude toward government remains decidedly downward.

4 Not all see declining trust in government as a problem, but most do.

5 See NYE, ZELIKOW, AND KING (1997); HUNTER AND BOWMAN (1996); and THE PEW RESEARCH CENTER FOR THE PEOPLE AND THE PRESS (1998).

ernment has to earn. The right amount of trust in government depends on how well government performs. A well-functioning democratic government deserves more trust than an inefficient, despotic one. That we should increase trust in government by improving its performance is so obvious that it is amazing it receives so little attention compared to the view that we can improve government performance by increasing trust. One explanation for the emphasis on trust prior to performance follows from public choice considerations. Narrowly focused interest groups can secure private gains at public expense more easily when there is a high level of public trust in government. The greater the trust in government, the greater the political power to be captured by organized interests and used to expand and divert government into activities that harm the public by undermining economic efficiency.

So while the case is strong for a healthy skepticism about government, well-organized interests decry that skepticism, arguing for more trust in government in the name of achieving as much good as possible through the political process. Despite the special-interest pressure for what we see as too much trust in government, we do not deny that it is possible to have too little trust in government. Any reasonable discussion of the appropriate level of trust in government has to recognize the tension between improvements in government performance that can result, up to some point, from more trust in government and the power more trust gives government to expand beyond efficiency limits.

The exact nature of the trade-offs between trust in and performance of government depends upon the particular political institutions, with constitutionally limited democracy surely providing the greatest scope for beneficial trust in government. In fact, we will eventually argue that constitutional constraints can actually increase the scope of opportunities for beneficial trust in government. However, one attribute of voting severely limits the benefits of trust in such a government. Interestingly, this attribute is highlighted by Brennan and Buchanan (1984) in a work that implies that their 1988 concern that public choice might harmfully undermine trust in government is surely overstated, if not completely misplaced. Brennan and Buchanan (1984) begin with a fact often emphasized in public choice analyses: an individual's vote in an election is extremely unlikely to be decisive. They then examine an implication of this fact that has not been widely recognized, even by public choice scholars. They argue that since an individual vote is almost sure to have no influence on the outcome of an election, it costs the individual voter effectively nothing to make electoral choices for expressive, rather than instru-

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mental reasons. The voter who receives satisfaction from expressing support for a political proposal (e.g., helping the poor) will not be deterred from doing so, even though the high cost of the proposal, if passed, would have prevented him from voting for it if his vote were decisive. An important, but overlooked implication of this "expressive voting" is that the less decisive an individual vote, the more quickly trust in government will translate into voter support for a host of government activities that will be subverted by special-interest politics.

In the next section, we will consider how expressive voting and the difference between the political decisiveness of voters and organized interest groups explain how trust in government is exploited and subverted. In Section 3, we consider some of the circumstances that call for more or less trust in government, and the possibility of an interaction between expressive voting, trust in government, and government performance leading to long-run cycles between too much and too little trust. In Section 4, we argue that constitutional constraints on government can extend the range of government activities over which trust is beneficial. Concluding comments are offered in section 5.

### **II. Expressive Voting and Government Exploitation**

In the 1950s, Anthony Downs illustrated the tenuous connection between a voter's choice at the polls and the outcome of an election.<sup>6</sup> From this it is clear that voters quite rationally devote little time to becoming informed on political issues and realize little private advantage from voting at all, at least in terms of affecting the outcome of elections. However, people may realize satisfaction from going to the polls and expressing themselves in favor of candidates and issues they feel are deserving, and in opposition to those they feel are not. Indeed, the lack of decisiveness increases the private benefit realized from expressive voting, because it lowers the cost of political expression. In situations typically examined by economists, when an individual chooses one option, there is a clear opportunity cost in the sacrifice of another option. This opportunity cost is greatly reduced, if not eliminated, when one is voting. Because of the low probability that an individual's vote will

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6 See DOWNS (1957), chapters 11-14.

decide the outcome of an election, when faced with a choice at the polls between options A and B, the voter is unlikely to sacrifice the value of B *because* he voted for A. This disconnect between choice and cost can result in election outcomes significantly at variance with those voters would choose if their votes were decisive when, as is often the case, there is a difference between the option voters feel they should favor and the one that actually promotes their private advantage.<sup>7</sup>

For example, consider an individual who feels that protecting the environment is the right thing to do. Assume that he is considering a vote on a government proposal to reduce pollution<sup>8</sup> which, if passed, will increase his taxes by \$1,100 while providing him with \$100 worth of pollution reduction, for a net cost of \$1,000. We assume that he would decline to make a private contribution of \$1,100 to support the proposal, even though he knew that the contribution (whether or not matched by others) would do as much to reduce pollution as would the \$1,100 increase in his taxes. Will he vote against the proposal? Not necessarily. Voting for the proposal is far less costly than making a private contribution because the vote is almost guaranteed not to be decisive, while the decision to contribute privately is completely decisive. If, for example, the probability is 1/10,000 that his vote will break what would otherwise be a tie (an unreasonably high probability in most state or national elections), the expected net cost of voting for the proposal is only \$.10. So if the voter receives more than a dime's worth of satisfaction from expressing support at the polls for protecting the environment, then a yes vote is a bargain. In general, the less decisive his individual vote (the less electoral choice is connected to electoral consequence), the more likely a voter is to vote for a policy for expressive rather than instrumental reasons.

Expressive voting is a factor in electoral choice only when there is a difference between what is in voters' private interests and what they feel good supporting expressively. Plenty of such differences exist. For example, most people under age 45 are adversely affected by the Social Security program, yet, at least until recently, even young voters supported the program electorally (and much of this support continues). The main reason is surely that most people feel that supporting Social Security is the right thing to do. Simi-

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7 TULLOCK (1971), was the first we are aware of to consider the low cost of voting against one's private advantage when discussing the political popularity of transfer programs. BRENNAN AND LOMASKY (1993), provide the most complete economic analysis of the implications of the low cost of voting expressively.

8 Or is considering a vote on a candidate who promises to support such a proposal.

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lar arguments can be made for welfare programs, agricultural price support programs, minimum wage legislation, mandated benefits for workers, protecting public schools against competition, import restrictions, and many others. Most people are harmed by such government policies, but large numbers of voters have been led to believe that these programs promote noble social objectives and they feel virtuous expressing support for them. And the cheapest way to express this support, with the possible exception of casual conversation, is in the voting booth.

The satisfaction people realize from expressing support for policies that reduce their welfare is not exogenous to the political process. Politicians and organized interest groups have strong incentives to persuade voters to support public policies that benefit the organized interests at the expense of the general voter. Hence, all attempts to secure private advantage through political influence are masqueraded behind the rhetoric of public advantage. This public-interest rhetoric does not necessarily attempt to convince voters that the recommended policy will be good for them, only that it will be good for the country. Public choice economists often argue that political interest groups take advantage of rational ignorance to fool voters into believing that special-interest legislation improves their welfare. Certainly this happens. Lobbyists for import restrictions for their industry clothe their case in arguments suggesting that foreign imports threaten all American jobs. Those pushing for agricultural price supports try to convince people that without these supports, farmers will be driven into bankruptcy, and food prices will increase. But much special-interest lobbying attempts to win over those who are clearly harmed, at least to some degree, by the policy being advocated. We are encouraged to support welfare programs that will cost most of us money because we should help the poor, or minimum wage legislation that will increase some prices we pay because all workers deserve a living wage. Such lobbying is explained, at least in part, by expressive voting.

We acknowledge that many policies which voters feel good about supporting, even though they work against the voters' private interests, are not ones upon which they vote directly. There are three responses to this fact. First, there is a large and growing number of referenda on issues ranging from school choice to welfare eligibility for illegal aliens indicating that voters are faced with many opportunities for expressive voting. Second, representative government implies that a vote for a political candidate is a reasonable proxy for voting directly on issues. In fact, as reported by Kau and Rubin in 1993, to be elected requires that the representative be in agreement

with his constituency. Political markets do a good job controlling ideological shirking by legislators, which is strongly and quickly punished. Third, while political representatives may respond to public concerns, how those concerns are actually addressed depends far more on the influence of organized interests than on voter preferences. We elaborate on this point later in our discussion.

For our purpose, it is important to recognize that the greater the trust in government, the more satisfaction voters will realize from expressive voting and the more vulnerable they will be to the public-interest rhetoric of special-interest politics. People might be convinced that the poor should be helped, American jobs should be saved, or the environment should be protected, but if they have little confidence that government can accomplish these worthy objectives, they are less likely to achieve any expressive satisfaction from voting for government attempts to do so. So those whose interests are tied to expanding government programs wish to promote public trust in government whether or not that trust is warranted. Indeed, their motivation to promote such trust is surely greater the less that trust is warranted, since their ability to benefit politically at public expense is inversely related to the trustworthiness of government at promoting the public interest.

Unfortunately, people often trust government independently of how trustworthy government is. Since most people quite accurately feel rather powerless to change government policies, they take some comfort in believing that those policies are accomplishing the good things their proponents claim they are.

### **III. Subverting the Public Trust**

Communicating voter demand for a given amount of public goods does not ensure their efficient provision, or even their provision at all. Voting empowers government, but not necessarily to do what voters want. Voters may point government toward general objectives, but the power granted to achieve those objectives is invariably controlled by interest groups that determine the details of what is done. Also, these interest groups influence the agendas that get voted on, agendas which commonly have nothing to do with providing genuine public goods. And, the more the public trusts government, the more power organized interests have compared to voters.



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Consider that once voters have indicated majority support for a program, for example, to help the poor, they have taken only the first step in securing more government help for the poor. Taking the necessary next steps requires designing an effective program and then implementing it properly so that it actually performs as designed. Public input, in the form of informed citizens monitoring their political agents is crucial to ensuring that these steps are taken. But while voting for helping the poor costs an individual almost nothing, this is not true of becoming informed on the problems inherent in any attempt to help the poor, monitoring politicians and bureaucrats to see if they are avoiding these problems, and then attempting to correct them when they arise. Engaging in these activities is personally quite costly. Not surprisingly, once a person walks out of the voting booth feeling virtuous for voting to help the poor, he will spend more time watching TV commercials on hemorrhoid relief than working to improve the chances that his "compassionate" vote translates into real help for the poor.

We do not mean to imply that there will be little interest in the design and implementation of government poverty programs. Numerous groups stand to gain or lose, depending on how those programs work. Obviously the poor have an interest, but so do farm groups (which benefit from the food stamp program); physicians and pharmaceutical companies (concerned with Medicaid); the construction industry (public housing), along with the self-proclaimed advocates of the poor and employees of the agencies that administer these programs. Except for the poor themselves, members of all of these groups can capture private benefits with policies that do less than is possible to help the poor for the money spent. And again, except for the poor, all these groups can exert a lot of political influence because they are well-organized professionally, experts on the relevant programs, and vitally concerned with those programs.

Of course, members of these special-interest groups are no less concerned with behaving virtuously and doing the right thing by the poor than is the typical voter. So can we expect them, like the voters, to largely ignore their private interests and exert their influence on behalf of the needy? No. Not because they are less virtuous than voters, but because exercising that virtue costs them much more since their influence makes their "vote" far more decisive. If public housing contractors knew that their support for housing vouchers, which the poor could use to rent private apartments, would not reduce the probability of massive government funding for public housing construction, it would cost them nothing, in terms of the political outcome, to provide that

support. But since they can affect the outcome of housing policy, supporting housing vouchers requires they sacrifice a very valuable alternative. Like the demand curve for everything else, the demand curve for behaving virtuously is downward sloping. Virtue costs little in the voting booth, but it is expensive in the corridors of political influence. Public-interest considerations can control voter choices, but private interest is the dominant concern of special-interest groups.

So voters are seldom instrumental in achieving the noble objectives they vote for. They are, in fact, duped by the rhetoric of public concern and civic virtue into granting power to government that will be captured and corrupted by politically powerful private interests. This is true even when expressive voting communicates a public desire for something close to the efficient quantity of a genuine public good. It is even more true when, as is commonly the case, the temptations of expressive voting lead to public support for government actions that, despite the rhetoric, have nothing to do with public goods. The greater the public trust in the social good that government can do, the more easily that trust is subverted by the organized few into social destructive policies.

#### **IV. Some Additional Implications**

We have acknowledged that some minimum level of public trust may be necessary for government to function properly. But we have emphasized the negative influences of trust resulting from the indecisiveness of individual votes and the corresponding lack of any meaningful sense of voter responsibility for the consequences of electoral choices. We now consider some additional implications of expressive voting for the appropriate level of trust in government. An immediate implication of our discussion is that the more decisively the general citizen can influence political decisions, the more trust there can be in government before the benefit from that trust is offset by special-interest abuse. This suggests that citizens can safely trust local governments the more local they are, and there is evidence that they do. According to a recent survey of American opinion (Hunter and Bowman, 1996, p. 21),

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while just one-third of all Americans have "a great deal" or "quite a lot" of "confidence in the federal government," only a slightly greater number (39 percent) has the same level of confidence in state government. Yet as one moves to the local community, the sentiment of disaffection begins to change appreciably. ... Fifty-seven percent of those surveyed say that they are at least content, if not pleased with their local government.

According to a 1998 study by The Pew Research Center for the People and the Press, in 1997 every category (sex, race, age, education, and party affiliation) of respondents trusted (distrusted) the federal government less (more) than their state government to handle problems (The Pew Research Center, pp. 5 & 6). The message should be clear to those who want to restore trust in government; they should advocate more devolution of responsibilities from the federal level to the state and, better yet, local levels.

Voter decisiveness varies not only between levels of government, but also between different electoral decisions at each level. The probability of a decisive vote can vary significantly for a given number of voters, depending on how evenly the electorate is split.<sup>9</sup> Since trust in government can vary over issues, our model suggests that people should have less trust in government on issues for which there is large majority support than on those over which

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9 One might be tempted to argue that the probability of a tied election is so small, no matter how evenly the voters are split, that any relevant difference in this probability can have no noticeable effect on voter behavior. But this is not true, particularly for local elections, where the number of voters can be relatively small. For example, if the number of voters is 2001 and the voters are evenly split i.e., the probability is 1/2 that a randomly chosen voter will vote for A or B, then the probability that the total vote will end up 1000 to 1001 in which case each voter is decisive is 1/56. In this case the individual considering a vote for an environmental proposal that, if passed, will cost him \$1,000, would have to receive at least \$17.86 worth of expressive satisfaction to motivate him to vote yes. One can expect a lot less expressive voting when the cost is \$17.86 than when the cost is \$.10, as in our example in Section 2. Even when the number of voters is 10 million, the probability of a tie vote is only 1/4,000 when the voters are evenly split probabilistically. However, as the probability that a randomly chosen voter will vote for A and B diverges even slightly from 1/2, the probability of a tied election quickly becomes indistinguishable from zero, with the decline more dramatic the larger the number of voters. See BRENNAN AND LOMASKY (1993), pp. 55-59, for more detail on the relevant calculations.

the public is evenly divided. Of course, overwhelming support for an issue may reflect the fact that the government can, with good reason, be trusted to handle it competently. But surely, people often place a lot of trust in government to perform particular tasks because of the expressive considerations discussed earlier. They believe some things are important to do, and they can feel better about themselves by first trusting in, and then voting for, government to do them. Consistent with this view are recent survey data showing that even when people have little trust in the general performance of government, they seem to trust government's ability to perform specific and emotionally appealing tasks. For example, The Pew Research Center study just cited found that 72 percent of those surveyed favored government's ensuring that no one goes without food, clothing, or shelter, and 74 percent thought it was government's responsibility to eliminate poverty in the country. But in the same survey, 64 percent agreed that government controls too much of our daily lives, and 57 percent agreed that government regulation does more harm than good (The Pew Research Center, p. 16). So the temptation to trust government on specific issues is obviously strong enough for significant majorities to do so, and this is precisely why the trust is misplaced. The more overwhelming the vote, particularly when based primarily on expressive rather than instrumental considerations, the greater the power transferred to government, and the less the accountability of those who will end up controlling that power.

Similarly, the greater the emotional appeal of an issue, or the more charismatic a favored political candidate, the smaller the desirable level of trust for a given degree of voter decisiveness. The lower level of trust is needed to counteract the temptation voters feel to make decisions on emotional grounds with little regard for the collective consequences.

Let's consider again proposals to protect the environment which, because they are packaged in emotionally appealing ways, tend to command overwhelming public support regardless of their benefit/cost implications. When expressive rather than instrumental considerations dominate voter choice, voters will favor pollution-control proposals that, even if implemented efficiently, cost more than they are worth, and empower organized groups to benefit from inefficient pollution-control approaches. For example, the uniform requirements typical of the command-and-control pollution approach allow well-established firms to restrict the entry of competitors and impose

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disadvantages on smaller, less-established competitors.<sup>10</sup> Also, government agencies enforcing environmental laws can justify larger budgets under the command-and-control approach because it requires more detailed involvement in pollution-control decisions.<sup>11</sup> Unfortunately, these special-interest benefits come at an enormous cost. The uniform requirements of the command-and-control approach can cost 22 times more than the least-cost approach for the same amount of pollution reduction.<sup>12</sup> The inefficiencies in pollution policy would be reduced, though never eliminated, if the emotional appeal of environmental protection were countered with more skepticism about government's ability to protect the environment.

Nothing in our discussion suggests any natural tendencies toward the desirable trust in government. We could emphasize that people trust local governments more than the federal government as an indication of such tendencies, but in 1972 exactly the opposite was true (The Pew Research Center, pp. 6 & 7). As should be clear by now, we see strong and unrelenting pressures toward too much trust in government, although most discussions on trust in government we have read see a destructive dynamic leading to not enough trust. For example, according to Nye (1997, p. 4), "And if government can't perform [because of the lack of public trust], then people will become more dissatisfied and distrustful of it. Such a cumulative downward spiral could erode support for democracy as a form of governance."

We do not dismiss Nye's concern, but we see it as less of a concern and more of a reassurance. We believe that the level of trust in government is subject to negative feedback. Trust is also subject to long cycles around some central, though unlikely most desirable, level, and the departures from that optimum are significant. Unlike Nye and others who worry about the erosion of trust in government, we have emphasized the power of organized interest groups to promote trust in government, and then, exploit that trust to secure private advantage at public expense. This power and exploitation, however, can eventually sow the seeds of their own destruction by creating mistrust in government. These seeds can take a long time to germinate and grow given the resistance of rational voter ignorance and apathy, the temptations of ex-

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10 The literature on this subject includes work by ACKERMAN AND HASSLER (1981); BUCHANAN AND TULLOCK (1975); MALONEY AND MCCORMICK (1982); and PARSHIGIAN (1984).

11 As observed in *The Economist* (1991), p. 28, "The EPA exists to regulate things, not to see the market do the job for it."

12 See TIETENBERG (1992), pp. 402-405.

pressive voting, and a growing number of influential interest groups. But eventually, as government expands too far and its failures dominate its successes, public trust will reverse and begin declining.<sup>13</sup> During the decline phase, trust can fall too far, with the arguments of those who are worried about the erosion of trust in government becoming relevant. But, with a lag, declining trust can cause reductions in the size of government and the power of interest groups, with improved government performance over a more limited range of activities. The result can be a reversal in the declining trust in government, and the beginning of a new cycle as trust begins increasing.<sup>14</sup>

Information on public trust in government going back to early in this century is sketchy, but what does exist, along with more recent data, is consistent with long cycles.<sup>15</sup> Robert Lane detected an increased trust in government in the 1930s, which he saw resulting from the expectation that the federal government could bring the economy out of depression.<sup>16</sup> We add that the relatively limited economic role of the federal government into the 1930s, along with the perceived success of many of the progressive measures enacted earlier in the century, was also important in the increased trust in govern-

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13 SAMUELSON (1995), pp. 200-201, discusses this phase of the cycle in trust in similar terms when he says:

There is a vicious circle. Government that grows must do more of its work in obscurity; otherwise, it could not function at all and would inevitably fail in many of its missions. But government that works in obscurity will become increasingly dominated by narrow groups, which will bend it to their own purposes and make government seem even more removed from popular will.

14 ARTHUR SCHLESINGER (1986), p. 245, considers this stage in the cycle when he comments, "The fewer responsibilities loaded on the national authority, the better it will be able to discharge those it cannot escape." And three sentences later, he points to the beginning of the next stage in the cycle: "Sometimes government intervenes too much. Its regulations become pointlessly intrusive. Its programs fail. After a time exasperations accumulate and produce indictments."

15 One could argue that the polls from which our information on trust in government is drawn are also flawed because of "expressive voting." For example, when the polls are taken, no individual attaches any instrumental or outcome significance to his or her response and therefore, expressive motivations dominate the responses they give. However, there is no reason to believe that any distortion resulting from this phenomenon has changed over time. So while the magnitude of the trust or distrust may not be accurately measured by the polls, the directions of change should be.

16 Lane's observations are discussed in NYE (1997), p. 10.

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ment, an increase that probably began earlier than the 1930s. Data from University of Michigan polling that began in 1958, indicate that trust in government continued to increase into the 1960s, peaking around 1964. Since that time trust has declined significantly (though not monotonically), with it reaching about 25 percent in 1994.<sup>17</sup> This decline in trust coincides with the expansion in the federal government's economic role and corresponding increase in federal spending, beginning with President Johnson's "Great Society" initiatives in the mid-1960s, which have been largely subverted by organized-interest groups and seldom generated the public benefits promised. Whether this decline in trust results in a significant reduction in government spending and influence, with an eventual turnaround in public trust, remains to be seen.

### V. The Case for Constitutional Constraints

A clear understanding of the role of trust in government and the problems associated with expressive voting also provides a strengthened case for constitutional constraints. It is entirely feasible that well devised constitutional constraints can effectively expand the realm of government activities over which public trust is both warranted and beneficial. For example, a constitutional limitation prohibiting the Federal Reserve System from expanding the money supply faster than the real growth rate of GNP could significantly increase trust in the government's ability to maintain a stable price level. This same constraint could limit government's ability to become Leviathan by financing it's expansion through money creation. A constitutionally imposed flat tax could increase all taxpayer's trust in government since an individual's taxes could not be changed without changing those of all other taxpayers simultaneously. As illustrated by Brennan and Buchanan in their 1980 treatise on *The Power to Tax*, "if government is constitutionally required to follow precepts of generality in its fiscal dealings with citizens the revenue potential that could possibly be derived from sophisticated discrimination among separate persons and taxpayers is foreclosed." We contend however, that such constitutional constraints would also be subject to cycles of public trust in government and therefore, limited in effectiveness. As early as 1951,

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<sup>17</sup> See reference in endnote 1.

Henry Simons supported this notion with the position that "Constitutional provisions are no stronger than the consensus that they articulate. At best, they can only check abuses of power until moral pressure is mobilized; and their check must become ineffective if often overtly used."

## **VI. Conclusion – Is Trust Incompatible with Trustworthy?**

Addressing the issue of trust in government requires considering how good an agent government is to the general interest of the public. The better agent government is (the more control the general public has over it), the more trust it can safely be granted. The more trustworthy the government, the more it can be trusted. While this point seems obvious, it is often ignored by those who want more trust in government. But we agree with those concerned with the erosion of trust that the connection between trust and trustworthy is more complicated than putting trustworthy before trust. Surely, without some minimum level of trust, a government cannot be trustworthy. But we believe that this minimum level of trust is very minimal, with trust in government easily increased into the range in which it destroys trustworthy government.

Certainly when trust has reached the point where government action is recommended for solving almost every imaginable social problem, it is inconsistent with government's performing in a way that justifies that trust. Such a level of trust will open the door for politically compelling demands for government to do things it cannot do, or only do poorly, at costs that exceed the benefits. Public skepticism is necessary if government is to be limited to activities in which it can add to social value. Such skepticism is needed to overcome the temptation of voters to feel good by supporting government programs that will invariably be corrupted by organized interests. What do we mean by a healthy dose of skepticism in government? A level that would find a majority of voters feeling noble about voting against government proposals, no matter how noble the objectives of those proposals are claimed to be. Finally, constitutional constraints can extend the realm of activity over which trust in government can be both beneficial and effective and significantly reduce the need for Buchanan and Brennan's 'Nobel lie'.



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## 16 The Calculus of Dissent: Constitutional Completion and Public Goods

GIUSEPPE EUSEPI

- I. Introduction
- II. The Non-Exhaustiveness of the Two-Stage Models
- III. The Introduction of a Third-Stage in Constitutional Political Economy
- IV. The Problem of Dissent, and Its Solution through Consensual Constitutional Changes
- V. When Rules Come from Random Choices
- VI. Concluding Remarks

Starting from the two-stage model underlying constitutional political economy, this work suggests the introduction of a third stage with the aim of solving the problems, which under certain conditions arise in the public goods market. These problems may be due to: a) a centralized institutional framework, and b) the impossibility to reach an agreement following the majority rule.

In the three-party/three public goods scheme with completely conflicting outcomes (three different choices) in case a), conflicts could be solved resorting to a federal organization; this, however, would involve a constitutional break off. For the solution of the problem in b), the work addresses a completely neglected issue using a new approach centered around the concept of *residuum of consent vis à vis* the emergence of dissent. Since choices are never consensual here, and choosing is nevertheless unavoidable the contractarian logic may survive only by resorting *consensually* to a lottery which assures a random choice. The last part of the paper indicates some fiscal devices to correct inequalities coming from drawing lots; such devices are based on the benefit principle.

GIUSEPPE EUSEPI

## I. Introduction

As for many other papers of mine, James Buchanan has indirectly inspired also this one. Yet, as this is not a work following in Buchanan's footsteps I shall try to render a critical account of what seems to me the shortcoming of the two-stage scheme in contractarian constitutional political economy. It is precisely this dissatisfaction which has spurred me on to this effort.

Although my belief is that the two-stage model of constitutional contractualism has reached its maturity at the end of the 90s, I nevertheless seek to demonstrate that this maturity does not stand for senility and, in fact, further developments, though dimensionally circumscribed, are at hand. The first point, which will be convenient to discuss in detail, is the somewhat debatable usage of the word contract as though it were a perfect equivalent of consent. That is why in the literature the two terms are employed in a neutral manner.

I think that this neutral usage would trivialize the heuristic importance of the contract. And in fact how could the case of conflictual choices over public goods in a certain political context be solved? Since a consensual choice is impossible here, and since the equivalence assumption impedes that a contractual procedure be used, the only option left will inevitably lead to revolutionary or dictatorial resolutions. This case indicates that the democratic process itself pushes towards a non-neutral usage and, in fact, the contractual route extends the contractual solution to dissent. It is therefore one of the main tasks of this work to employ the contractual procedure in the calculus of dissent.

Section 2 proceeds by defining the foundations of the dissent problem and shows that the two-stage model is logically consistent, but lacks in exhaustiveness; thus Section 3 suggests its completion through the introduction of a third stage whose nature is however different from the first two stages, and for this reason is labeled as spurious.

Section 4 deals with dissent in a centralized organization of the polity, while in the fifth Section dissent is within the constitutional framework itself. While in the first case it is possible to reach a consensual result through the creation of federal institutions, in the second case the recourse to random choices as a way to overcome the problem of dissent is required. I strongly emphasize here that the dissent problem in the post constitutional market

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does not imply the abandonment of the two-stage model at all. Section 6 will offer some concluding remarks.

### II. The Non-Exhaustiveness of the Two-Stage Models

The distinctive element in contractarian constitutionalism is the consent that is in fact at the basis of both initial constitutional designs and their revisions. Quite independently of the two-stage model adopted (*à la* Hobbes, *à la* Buchanan, *à la* Frey<sup>1</sup>), rules are constraints to post-constitutional decisions. The reasoning is, of course, correct, but it does not appear to be at all exhaustive. In my opinion, for the two-stage model to be exhaustive, one should prefigure the attainment of a consent without residua. In clearer words one should prefigure either a unanimous consent or in the worst of cases a simple majority to emerge. If for any reason a less than majoritarian<sup>2</sup> result should occur at a post-constitutional level, e.g. in the public goods market, the public goods domain itself will become *prima facie* a sort of contractual *vacuum*. If so, for the contractarians there would not be alternatives left, but the abandonment of the contractarian approach itself.

The work suggests that this is not the case, and in supporting this thesis it develops an idea recently launched by Buchanan and Yoon.<sup>3</sup> However, differently from Buchanan and Yoon, who are interested in showing the efficacy of arbitrary rules in a non-natural context<sup>4</sup>, I explicitly refer here to contractarian constitutionalism and impute the emergence of conflicts coming from residua of consent on the market of public goods to the non-exhaustiveness of

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1 I have shown elsewhere that Hobbes's model is not contractarian as suggested by Buchanan, and that, however strange this may appear, the model *à la* Buchanan and *à la* Frey largely overlap, and even where these models appear to be conflicting, they complete each other. See G. EUSEPI (1999).

2 In this case, of course, the dissent among the parties rather than the consent becomes the characteristic feature. Consequently, on the grounds of the dominant theory on the calculus of consent, the tragedy of being constrained would re-emerge.

3 J.M. BUCHANAN, Y.J. YOON (1997).

4 The natural context is, of course, the constitutional one and consequently the non-natural context is the one in which there is not a clear-cut distinction between choice among rules and choice within the rules. It is evident that from Buchanan and Yoon's viewpoint this paper falls under the natural context .

the deductive or the *ex ante* two-stage scheme. In a sense, in contractual constitutionalism - no matter whether in the Rawlsian version of the veil of ignorance or in that of Buchanan-Tullock<sup>5</sup> - there is too much optimism because given consensual bindings a simple majority decision will always emerge on the political market. This ensures not only that the tragedy of being constrained is overcome - since the principle of majority-minority rotation which is at the root of democracy smoothes the problem - but also that within the *rotation limits*, an equilibrium on the public goods market will always emerge. If instead one would demonstrate, as I shall try to do here, that it is not always possible to reach an equilibrium at a second-stage, or public goods level, we might as well abandon, at least within the limits of these residua of consent conditions, the deductive perspective based on consent over rules and adopt a random choice criterion which involves the resorting to a "lottery" by drawing from a ballot-box - which contains all possible alternatives - the winning one which is legitimated just because individuals' choices have an equal probability to be drawn. The drawing-lots-procedure may appear not to have any linkage with the decision taken behind the Rawlsian veil of ignorance - and in fact here we are dealing with a self-determined individual who is able to know exactly which alternative is the best to him. Yet, he also knows that neither his own choice, nor that of anybody else will have any chance to prevail. In a sense, we could say that each decision-maker has *too much information*, and not too little.<sup>6</sup> It is as if he were set beyond the Rawlsian veil. His choice, however, cannot be totalitarian having the same weight as any other choice taken by anybody else in the polity. Indeed, these choices are mutually exclusive since they are at the same time equally weighing and diverging. There is surely not much room left for dictatorship here! In other words if everybody is a potential dictator, no dictator will prevail. It is easy to concede that the contractarian perspective turns out to be winning, even when a majority does not emerge; the non-trivial point that stands out from this kind of analysis is that the contractarian logic may prove to be a useful tool, although admittedly with some qualifications, also in the calculus of dissent.

It is precisely the reciprocity principle inborn in the contractarian constraint that makes drawing lots consistent, and *a fortiori* non-dilemmatic. Thus resorting to drawing lots, although admittedly in an indirect and surely

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5 J.M. BUCHANAN, G. TULLOCK (1962).

6 See G. BRENNAN, L.E. LOMASKY (1989), especially Introduction and ch.2.

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non-trivial way, resolves the tragedy of being constrained. Along this line of reasoning each individual's consent to abide by the potential rule, which emerges from drawing lots, will restore to certain extent an environment of equal uncertainty not so far from that created through the veil of ignorance or uncertainty in a Rawlsian setting. The point, however, has not to be overstressed; the veil here originates from a failure on the public goods market and it is in a sense a further barrier against dictators.

However, if the Rawlsian veil became transparent, it would be used by dictators to determine their own best results and to create *ex post-justificatory* rules. And, in fact, as happens in the Rawlsian case, the drawing from the ballot box involves the constitutionalization of the choice. Such a choice, however, cannot be considered as a genuinely constitutional one in the light of the two-stage scheme. Resorting to a lottery could *prima facie* appear an incorrect procedure, and into the bargain, it would be incompatible with both majoritarian democracy and consensual contractarian constitutionalism.

Under the dissent condition - although within limits - the random choices we have to resort to may offer a solution to non-consensual choices; this requires that the contract as an instrument of analysis be extended far beyond consensual choices, which are believed the only contractual ones. In order to separate also semantically the constitutional reforms of the standard two-stage paradigm from reforms deriving from the constitutionalization of a public good, I suggest naming the latter case constitutional completion.

### **III. The Introduction of a Third-Stage in Constitutional Political Economy**

I shall leave out the presentation of a two-stage model because after two decades of numerous and weighty writings all that which matters<sup>7</sup> has already been said. For this reason one of the objects of this work is to deal with what seems to me the foundation stone of contractarianism, and seeks to focus on the renegotiability of a Constitution. If the initial contract does not provide constitutional renegotiation, even its being approved under the most rigorous version of Wicksell's unanimous consent becomes irrelevant. In any case, if

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<sup>7</sup> See for instance J.M. BUCHANAN (1975), G. BRENNAN, J.M. BUCHANAN (1985), D.C. MUELLER (1995).

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the two-stage scheme is unable to impede the rising of major conflicts on the political or public goods market, the addition of a third stage to the original scheme is unavoidable. A third stage is, of course, not needed if we assume that in the public goods market there will always emerge Lindahl-Samuelson-like equilibria.

Note, however, that in an ordinary democratic context, the majority makes the rule, and the minority is ruled. I haven't, of course, much to re-criminate against all this. I have something to say, instead, on the generality of the majority rule. In some cases, in fact, the majority rule may turn out to be unattainable, so I shall define this situation - where decisions are conflicting rather than consensual - as the dissent case.

One can readily realize that if none of the proposals win, all outcomes derive from the minorities and all decisions are inconsistent. Clearly, one thing is the lack of consent by the minority when there exists a majority; a completely different thing is the dissent case where all outcomes get the support of the minorities. These differences can be, in part, attributed to the type of institutions in existence, e.g., a too centralized state.

The emergence of a dissent problem simply indicates that the two-stage constitutional model needs to be completed, and this can be done through adding a third stage. The latter stage, however, is ostensibly spurious; in fact it springs up only as a consequence of a decisional problem in the political market and not *ex ante* because under a genuine constitutional logic, rules must constrain individual choices, but for individual choices to be free acts these rules cannot impose mandatory behaviors.<sup>8</sup> If the rule is viewed as a guarantor of freedom, it cannot permit forecasting which decisions individuals will actually take about certain matters, precisely because every individual choice is a free act and, hence, an unpredictable event.<sup>9</sup>

On the other hand, the representatives, who are the most important decision-makers in public economy, could fail in reaching the required consent, or even give up the consent *stricto sensu* as a decisional tool due to the high transaction costs, or simply because public goods might be conflicting.

The conflicts emerging in the decision over public goods, could be *prima facie* a sign, not only of the failure of the initial constitutional design, but of the contractual constitutional revision as well, since in both cases choices are based on consent. The reason why I am introducing a third stage is that of

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8 See B.S. FREY (1996).

9 J.M. BUCHANAN (1969).



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extending the contractarian logic far beyond consent, where it is the dissent which dominates. This expression, however, may be particularly ambiguous, and it needs to be clarified. Firstly, it could be understood as if simple majority decisions were descriptive of dissent; I shall not, of course, argue for this understanding of dissent because majority decisions in any case warrant that in the aggregate the consenters prevail over the dissenters. It is perfectly logical that the consent of the majority rather than that of the minority, which in fact suffers it, decide the rule. (This is the core of democracy.)

The contractarian theory has assumed the contract as synonymous with consent because contracting parties, which are necessarily free, could but consent freely on rules. In the real world constitutions and institutions in general, the contract/consent equivalence - under the residuary conditions here discussed - could impede the attainment of results which, although necessarily of *third best*, would nevertheless represent the only way to prevent the falling back into chaos. Since, however, the aim of the initial constitutional contract was that of breaking away from chaos, the decisions involving dissent - and therefore a relapse into chaos - require, as seen, the reconstruction of something similar to the Rawlsian veil of ignorance. The thought experiment of equal uncertainty about the results that will come out makes reasonably acceptable the different weight that the individual choices have in case of dissent.

It is maintained here that the random choice, or the draw from the ballot box, with individuals in a position of equal uncertainty, may mimic the Rawlsian experiment. Clearly, positions of equal uncertainty assign the vote an equal probability of success *ex ante*, so guaranteeing an equal weight to the vote; in this way the basic democratic principle "one man one vote" seems safeguarded, and in any case, it solves the decision problem in the public goods market when there is a dissent. Most of the remainder of the paper deals with this matter.

The dissent argument interjects a sort of interconnection between the constitutional market and the post-constitutional or public goods market, and makes the complete separation of the two stages impossible in logical-procedural terms. This interconnection could be named as feedback effect, and in fact the dissent at a post-constitutional level must find a solution which is to be constitutionalized. However, even accepting that the contractarian position - which involves a dissent - is correct, should be nevertheless recognized that the outcome which emerges may appear strongly unequal,

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not only to an external agent who evaluates it, but also to most of the individuals involved in the decision.

Let us start with a three-individual example facing the choice of three public goods, and let us imagine that the three individuals represent the electorate or the Parliament in a centralized polity (as an alternative we may refer to three political parties each of which is made up of one-third of the Parliamentarians and hence all three make up 100% of the Parliamentarians). In this case the Parliament is the only place entitled to decide and its decision binds all members of the Parliament (electorate). Since decisions are taken by individuals/parties whose choices may be homogeneous or different from each other, three outcomes may emerge. It may be useful to represent the three outcomes geometrically. Let  $A, B, C$  be the individuals/parties and  $a, b, c$  the payoff vectors.

In Fig. 1 there is a 100% consent on the payoff, hence the resulting vector lies along anyone of the axes; in this case it is indicated the  $Y$  axis.

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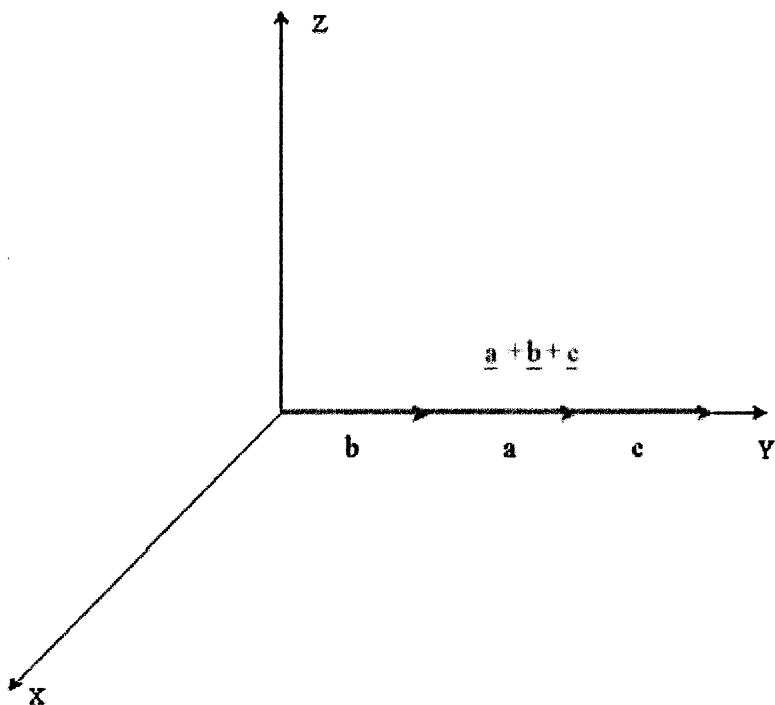


Fig. 1 A geometrical representation of unanimous consent

The outcome is a unique payoff vector ( $\underline{a}+\underline{b}+\underline{c}$ ) lying in any one of the axes (it is immaterial whether the axis is X,Y,Z) and its length is three times that of each vector. As the choice is consensual, the angle the resulting vectors make up with the chosen axis is null.

### **The payoff vector lies along one axis**

Fig.2 illustrates a majoritarian choice, in this case the resulting payoff vector is represented by the diagonal of the rectangle contained by  $a+b$  and  $c$ .

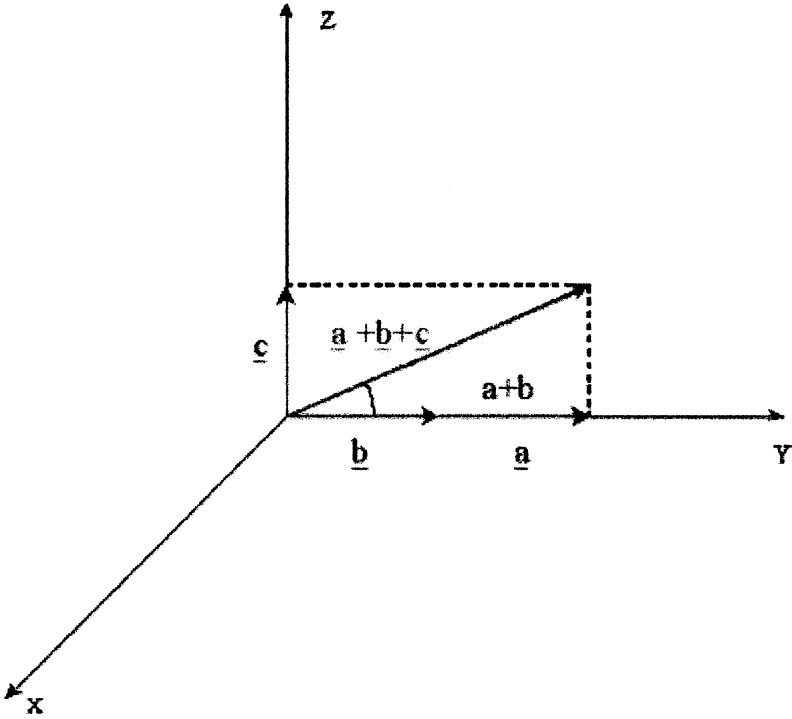


Fig.2 A geometrical representation of a majoritarian consent (A+B vote for the same alternative)

The payoff vector ( $\underline{a}+\underline{b}+\underline{c}$ ) belongs to the YZ surface, since the  $\underline{a}$  and  $\underline{b}$  vectors have been drawn along the Y axis and  $\underline{c}$  along the Z axis. It represents the diagonal of the rectangle contained by  $\underline{a}+\underline{b}$  and  $\underline{c}$ . The angle the resulting vector makes up with the Y axis is smaller than that made up with the Z axis.

**The payoff vector lies in the plane surface**

Fig.3 represents the dissent case. The resulting payoff vector ( $a+b+c$ ) does not lie in any of the surfaces ( XY,XZ,YZ ) of the three dimensional space; it is, in fact, the diagonal of the cube, and the payoff vector is contained in the space.

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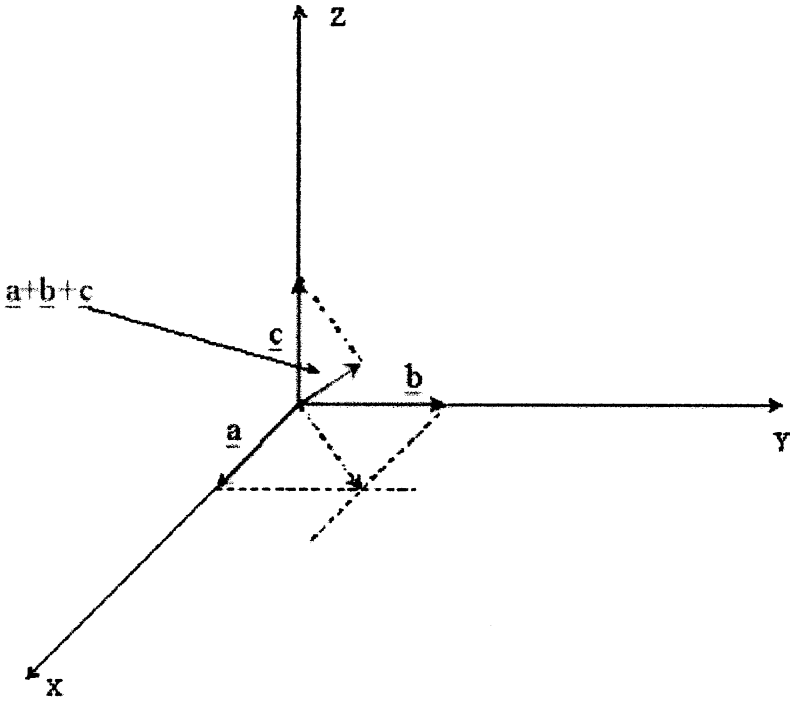


Fig. 3 A geometrical representation of dissent

The resulting payoff vector ( $\underline{a}+\underline{b}+\underline{c}$ ) does not lie in any of the XY, XZ, YZ surfaces, but it is the diagonal of the cube whose edges represent the choices  $\underline{a}$ ,  $\underline{b}$ ,  $\underline{c}$  made by A,B,C. The  $45^\circ$  angle this resultant forms with each of the addends represents the "equidistance" from any choice.

### **The payoff vector is contained in the space**

In the first alternative a centralized polity may appear not only perfectly compatible with individuals' freedom, but the decision which emerges is also effective and, within limits, efficient. Note, however, that this result is incompatible with the hypotheses that individuals/parties are different, since the decision of 100% would imply that individuals/parties are homogeneous.<sup>10</sup>

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<sup>10</sup> Homogeneous parties would equal, of course, to a unique party.

Once the first alternative is discarded due to its internal inconsistency, there may emerge either of the two alternatives. Since the majoritarian alternative is not relevant to my discourse, I leave it out of consideration; I focus, instead, on the third alternative that is relevant to my model dealing with dissent.

#### **IV. The Problem of Dissent, and Its Solution through Consensual Constitutional Changes**

The example given by Buchanan and Yoon falls in perfectly with the third outcome of my discourse, and, in fact, depicts a context of three individuals who have to take decisions about "thermostat setting", "lights-out time", and "visitors access" in a student dormitory. *Ceteris paribus*, individual choices depend on individual tastes or needs, but, due to the institution here considered (one room to be shared among three students), individual tastes and needs are met with public goods. The implication is that if it were possible to privatize the three goods, as a consequence of institutional changes, we would not have the third result any more and, in fact, everyone would choose according to his opportunity costs. This is made possible by dividing the room into three single rooms; the three individuals will, of course, pay different prices for heating, electricity, and moreover, they will be able to decide autonomously their visitors' access.

In this case the consensual choice has not involved a mere change in the *status quo* - that is a constitutional revision - it has instead required a radical overturning of the basic constitutional model. In order to make the Buchanan and Yoon's example more palatable at a constitutional and political level, let us imagine that the three actors of the model are not the three students any more, but the three political parties mentioned above. Let us start again with the dissent, or the three-minority case that impedes the decision in the centralized polity.

Conflicts on the public goods market, coming from a centralized system (typical of a unitary state) may find its natural solution by creating a federal system. This solution could be wholly consensual (see Czech Republic and Slovakia, or Belgium), but the contractarian logic must be extended also to decisions which are consensually residuary so that all the emerging rules would be *minority rules by definition*. To a certain extent, when a minority

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imposes on other minorities, these minorities could be viewed as majorities opposing the decision imposed by the minority. So interpreted, however, this context would be descriptive of a Leninist regime violating democratic procedures.

A constitution of three federate states would allow to reach all decisions by consent, without any dissent. Since in the federal alternative problems linked to dissent are settled by consent, we need not to resort to the constitutionalization or parameterization of a public good to facilitate choices, as Buchanan and Yoon suggest. I assert again, however, that the removal of conflicts is not a result reached through amendments or restoration of the original model. As said, the centralized polity model has been simply replaced with a three-federate-state model. An example, drawn from the Italian constitutional history, can corroborate the whole reasoning.

During its preparatory work, the Constituent Assembly (1946-47) faced up to the problem of relationships between the Republic, which was about to be born, and the Catholic Church. Leaving aside all the complexities of this matter - the most important of which probably lies in being a relationship between two different states, and as such should fall outside the constitutional field - I shall confine the analysis to the two possible alternatives: (1) to include the Lateran Treaties in the Constitution; (2) to proclaim freedom of religion.<sup>11</sup>

The approval of the first alternative has involved not only a continuity with the former Fascist regime (which signed the Lateran Treaties in 1929), but also the recognition of Catholicism as a sort of state religion, so discriminating against all other religions. Although the majority of the Italian citizens were Catholic at that time, and still are nowadays, the evolution of moral sentiments in the 1990s, in Tideman's words<sup>12</sup>, might then lead to choose the freedom of religion alternative.

The constitutionalization of freedom of religion would allow overcoming the discriminatory principle embodied in the first alternative, and reach consent on the religion argument. The second alternative recognizes non-Catholic minorities to follow their own religion. This reasoning is in actual fact an application of the classical theory of clubs, and of the recent theory of FOCJ which are able to eliminate the dissent.<sup>13</sup>

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11 The reading of art.7 of the Constitution is quite ambiguous, but in the end it assumes the first alternative.

12 N.TIDEMAN (1997).

13 J.M.BUCHANAN (1965), B.S.FREY, R.EICHENBERGER (1996).

## V. When Rules Come from Random Choices

Does there exist a different way from federalism able to solve the conflicts coming from dissent without resorting to the upsetting of the whole basic constitutional model? Following again Buchanan and Yoon (1997) this possibility of completion, which allows remaining within the original constitutional scheme, is feasible through the constitutionalization of a public good as an alternative way to come out of the third and the worst case.

If everyone votes for his own option in the all possible pairwise votings, every choice - apart from the voting sequence - will have one vote in favor by the proponent and two votes against by the non-proponents. The emerging solution, in which all alternatives get an equal number of votes in favor, could be depicted in words which would appear seemingly peculiar "the contractarian calculus of dissent" where the contractarian component is maintained since the procedural choice implies the acceptance by all individuals in conflict to refrain from using the force.

All things considered, no choice based on consent would be possible here, unless a rule-making minority is conceived. But this should be extended also to the other two minorities; consequently, one should prefigure a three-minority context where all minorities are rule-makers and none will be ruled. This is patently absurd. Clearly, on the basis of both unanimity rule and majority rule, none of the minorities is entitled to rule. Because choices on goods are conflicting, and goods are public, individual demands would sum up algebraically, and the sum will always have a negative sign.

So far the exit from chaos through consent - which the democracy's philosophers thought to be the aim of a constitution - would seem hardly attainable in the public goods market; it follows that a metarule making the drawing of lots compulsory has to be introduced.

Although the solution to the dissent problem through the device of drawing lots is reasonably the only one justifiable *ex ante*, it is likewise clear that the positions or the results, which the metarule gives rise to, may give rise to strong inequality *ex post*. Positions or results will be optimal for the individual whose choice has been drawn while the other two individuals may find themselves, more or less, in an equally bad position if the choice drawn is the median one; if instead, the alternative drawn is one of the extremes, the worst position is that of the individual who is positioned at the opposite extreme, while the position of the individual whose most preferred alternative is the



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intermediate one is worse, but better than that of the opposite extreme. Let us go back to the three individuals and the three public goods with three discrete values. The possible alternatives will be as many as the ordering set of triplets (See [3] in the Appendix):

$$S_{3,3}^{rep} = 3^3 = 27$$

The outcome may be:

1. Unanimous consent where each individual agrees on the same choice.
2. A majoritarian choice where two persons make the same choice.
3. Total disagreement where everyone chooses differently.

Let  $\bullet_1, \bullet_2, \bullet_3$ , be the three payoffs for the public good  $X$ , all possible results are illustrated in the following table

	A	B	C
1	$x_1$	$x_1$	$x_1$
2	$x_1$	$x_1$	$x_2$
3	$x_1$	$x_1$	$x_3$
4	$x_1$	$x_2$	$x_1$
5	$x_1$	$x_2$	$x_2$
6	$x_1$	$x_2$	$x_3$
7	$x_1$	$x_3$	$x_1$
8	$x_1$	$x_3$	$x_2$
9	$x_1$	$x_3$	$x_3$
10	$x_2$	$x_1$	$x_1$
11	$x_2$	$x_1$	$x_2$
12	$x_2$	$x_1$	$x_3$

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13	$x_2$	$x_2$	$x_1$
14	$x_2$	$x_2$	$x_2$
15	$x_2$	$x_2$	$x_3$
16	$x_2$	$x_3$	$x_1$
17	$x_2$	$x_3$	$x_2$
18	$x_2$	$x_3$	$x_3$
19	$x_3$	$x_1$	$x_1$
20	$x_3$	$x_1$	$x_2$
21	$x_3$	$x_1$	$x_3$
22	$x_3$	$x_2$	$x_1$
23	$x_3$	$x_2$	$x_2$
24	$x_3$	$x_2$	$x_3$
25	$x_3$	$x_3$	$x_1$
26	$x_3$	$x_3$	$x_2$
27	$x_3$	$x_3$	$x_3$

Alternatives are partitioned as follows:

1. Cases of unanimous agreement = 3. (See [3]).

A	B	C
$x_1$	$x_1$	$x_1$
$x_2$	$x_2$	$x_2$
$x_3$	$x_3$	$x_3$

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2. Cases of majoritarian agreement all over the decisions = 18. (See [4], [5])

A	B	C
$x_1$	$x_1$	$x_2$
$x_1$	$x_1$	$x_3$
$x_1$	$x_2$	$x_1$
$x_1$	$x_2$	$x_2$
$x_1$	$x_3$	$x_1$
$x_1$	$x_3$	$x_3$
$x_2$	$x_1$	$x_1$
$x_2$	$x_1$	$x_2$
$x_2$	$x_2$	$x_1$
$x_2$	$x_2$	$x_3$
$x_2$	$x_3$	$x_2$
$x_2$	$x_3$	$x_3$
$x_3$	$x_1$	$x_1$
$x_3$	$x_1$	$x_3$
$x_3$	$x_2$	$x_2$
$x_3$	$x_2$	$x_3$
$x_3$	$x_3$	$x_1$
$x_3$	$x_3$	$x_2$

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3. Cases of dissent = 6 (See [2]).

A	B	C
$x_1$	$x_2$	$x_3$
$x_1$	$x_3$	$x_2$
$x_2$	$x_1$	$x_3$
$x_2$	$x_3$	$x_1$
$x_3$	$x_1$	$x_2$
$x_3$	$x_2$	$x_1$

Note that in the calculation of the alternatives the order of the arrangement is fundamental!

$\bullet_1 \bullet_1 \bullet_2$ ,  $\bullet_1 \bullet_2 \bullet_1$  and  $\bullet_2 \bullet_1 \bullet_1$  represent three different alternatives even though they give rise to the same kind of majority/minority.

Let us extend our reasoning to a context in which the three persons  $A, B, C$ , have to decide about  $X, Y, Z$  each of which allows for three choices:

$x_1, x_2, x_3$  for public good  $X$

$y_1, y_2, y_3$  for public good  $Y$

$z_1, z_2, z_3$  for public good  $Z$

Up to this point we have examined only the  $X$  dimension. What we have said for  $X$  may be extended to the  $Y$  and  $Z$  dimensions since they are independent. Hence for each dimension 27 alternatives will emerge; for the three dimensions the total number of alternatives will be [1] in the Appendix.

$$27 \cdot 27 \cdot 27 = 19.683$$

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		X			Y			Z	
	A	B	C	A	B	C	A	B	C
1	$x_1$	$x_1$	$x_1$	$y_1$	$y_1$	$y_1$	$z_1$	$z_1$	$z_1$
2	$x_1$	$x_1$	$x_1$	$y_1$	$y_1$	$y_1$	$z_1$	$z_1$	$z_2$
3	$x_1$	$x_1$	$x_1$	$y_1$	$y_1$	$y_1$	$z_1$	$z_1$	$z_3$
4	$x_1$	$x_1$	$x_1$	$y_1$	$y_1$	$y_1$	$z_1$	$z_2$	$z_1$
.	.	.	.	.	.	.	.	.	.
.	.	.	.	.	.	.	.	.	.
.	.	.	.	.	.	.	.	.	.
$n$	$x_1$	$x_2$	$x_1$	$y_2$	$y_3$	$y_1$	$z_2$	$z_2$	$z_3$
.	.	.	.	.	.	.	.	.	.
.	.	.	.	.	.	.	.	.	.
.	.	.	.	.	.	.	.	.	.

The table illustrates some of the possible alternatives (samplings of 9 elements). Let us examine the  $n$  alternative:

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For decision  $X$                       A has chosen  $x_1$   
    B has chosen  $x_2$   
    C has chosen  $x_1$

For decision  $Y$                       A has chosen  $y_2$   
    B has chosen  $y_3$   
    C has chosen  $y_1$

For decision  $Z$                       A has chosen  $z_2$   
    B has chosen  $z_2$   
    C has chosen  $z_3$

We shall have of course:

3 cases of unanimous consent over the decision  $X$   
3 cases of unanimous consent over the decision  $Y$   
3 cases of unanimous consent over the decision  $Z$   
Hence (See [3]).

$$3 \cdot 3 \cdot 3 = 27$$

cases of total agreement or unanimous consent over all three decisions.  
18 cases of majoritarian consent over the decision  $X$   
18 cases of majoritarian consent over the decision  $Y$   
18 cases of majoritarian consent over the decision  $Z$   
Hence (See [4], [5])

$$18 \cdot 18 \cdot 18 = 5832$$

cases of partial or majoritarian agreement over all three decisions.  
6 cases of dissent over the decision  $X$   
6 cases of dissent over the decision  $Y$   
6 cases of dissent over the decision  $Z$   
Hence (See [2]).

$$6 \cdot 6 \cdot 6 = 216$$

cases of total disagreement over all three decisions.  
Suppose now that an agreement over a decision has been reached through a lottery. The total number of alternatives is reduced to (See [6]).

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$$27 \cdot 27 = 729$$

(Number of the alternatives for each decision, multiplied as many times as the decisions.)

If *B*'s choice is drawn, *A* and *C* will then suffer, more or less, an equal damage. If, instead, *C*'s choice is drawn the position of the other two will be different, and surely *A* will be more damaged than *B*.

From this, one could infer that contractualism might basically produce unfairness, notwithstanding procedural fairness. But this is not so. For instance, the Constitution could provide for a clause saying that in the case of a random choice, the individual whose option has been drawn, should pay more than the others. Let us go back to our example. If the choice is consensual, *ceteris paribus* each individual will pay a third of the total cost. If, instead, the rule comes out from a lottery the Constitution could impute, say, between 40 and 50% of the total cost to the winning individual. Despite the corrections advanced here and clearly based on the benefit principle, the equity problem is not fully solved; through the constitutionalization of this tax device a great political instability coming from an otherwise regressive tax system is nevertheless prevented.

## VI. Concluding Remarks

Although it can be maintained that there exist global markets (including some public services) and local markets (many local public services) quite independently of the political units or state organization, it does not follow that there is no link between the constitutional and the public goods market. This paper has sought to demonstrate that if the traditional two-stage scheme is supplemented with a third stage providing few appropriate constitutional devices it is possible to eliminate the case of dissent from the contract. This may be done by raising to the constitutional rank the choice that comes out from drawing lots.

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## Appendix

### GENERAL CASE

Suppose a set  $P = \{p_i\}_{i=1,2,3..}$  of persons who have to choose among a set of choices  $C = \{c_j\}_{j=1,2,3..}$  of a set of options  $O = \{o_k\}_{k=1,2,3..}$ . All possible alternatives are given by:

$$\prod_{k=1}^o [c(k)]^p = \prod_{k=1}^o S_{c(k),p}^{rep} \quad [1]$$

that is by the product made as many times as the number of options of the samples with replacement of  $c(k)$  elements of size  $p$ , where

$o$  = the number of options,

$c(k)$  the number of choices for the  $k$ th alternative,

$p$  = the number of persons.

Let us imagine  $p = 3$ ,  $o = 1$ ,  $c(1) = 2$  the possible combinations which may come out are represented by samples with replacement of two elements of class 3 selected three by three. The total alternatives are:

$$S_{2,3}^{rep} = 2^3$$

We examine only the case where the choices are equal or lower than the choosing persons  $[p \geq c(k)]$ . Only if  $p = c(k)$  for each decision we may have total disagreement or dissent. Hence,

$$(p!)^o \quad [2]$$

where  $p! = p(p-1)(p-2) \dots 3 \cdot 2 \cdot 1$  represents the number of permutations of  $p$  elements (samples without replacement of  $p$  elements  $p$  by  $p$ ). The cases of total agreement or unanimous consent will be

$$p^o \quad [3]$$

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If  $p > c(k)$  we will not have residuum of consent.

Let  $o = 1 \in c(1) = r$  (only one option among the  $r$  possible choices  $c_j, j = 1, \dots, r$ ). One of the possible ways to have  $n_1$  persons who agree on choice  $c_1, n_2$  persons agreeing on choice  $c_2, n_r$  persons agreeing on  $c_r$  is

$$\frac{p!}{n_1!n_2!\dots n_r!} \quad [4]$$

considering all the possible ways to obtain  $p$  as a sum of addends  $n_1, n_2, \dots, n_r$  the number of all combinations is

$$\binom{r+p-1}{p} = \frac{(r+p-1)!}{p!(r-1)!} \quad [5]$$

Going back to the  $o$  alternatives, assuming that  $p$  persons agree on one of them, the remaining alternatives which we may have are:

$$\prod_{k=1}^{o-1} [c(k)]^p \quad [6]$$

# 17 Pareto Optimality and the Rule of Law

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- I. Pareto and Wicksell in Buchanan's Political Economy
  - 1. Using the Pareto Criterion in Welfare Economics
  - 2. Unanimity in Political Economy
- II. The Rule of Law in Political and Legal Theory
- III. Law as Convention
  - 1. Constructive Unanimity and the Conditions of Conventionality
  - 2. The Principles of the Rule of Law
- IV. Rule of Law and Pareto Optimality

In 1959, James M. Buchanan criticized the collectivist misuse of *Pareto optimality* by the "new welfare economists" and made a first attempt to extend that individualist concept into the political realm.<sup>1</sup> Over the following three decades he further developed his political application of Pareto's insight to buttress an essentially economic analysis of political exchange that would justify the processes of constitutional democracy in the same way Pareto efficiency justifies free markets. In this paper I will explain why Buchanan's particular formulations will not work and propose a more comprehensive solution that accomplishes Buchanan's announced purpose. I will argue that a conventionalist understanding of the rule of law provides a precise and appropriate application of the Pareto criterion in the legal and political realm.

The Pareto criterion has been recognized for some time as a regulative norm by which the efficiency of an economy can be measured in terms of the extent to which the preferences held by individuals were satisfied. The point at which no further voluntary exchanges would take place marks a theoretical point at which everyone is as well off as possible, measured in terms of their own preferences. This differs from utilitarian and other approaches by taking

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1 J.M. BUCHANAN: "Positive Economics, Welfare Economics, and Political Economy", *Journal of Law and Economics*, 2 (1959), pp. 124-127.

the preferences of individual choosers as facts to be accommodated, not ignored or corrected.

The rule of law has been understood and defined in many ways, including as a regulative norm by some twentieth century legal, economic, and political theorists. Both F. A. Hayek<sup>2</sup> and Lon L. Fuller<sup>3</sup> have seen in this traditional legal concept an implicit guideline or measure of freedom as contrasted with tyranny. Michael Oakeshott further clarifies that observing rule of law in a polity is a means of ensuring that people are able to use their lives for their own purposes.<sup>4</sup>

## I. Pareto and Wicksell in Buchanan's Political Economy

Like other European sociologists and founders of welfare economics at the turn of the century, Pareto believed that social values should play a role in public policy analysis. But he also saw the need to transcend the necessity of interpersonal comparisons in utilitarian analyses. Pareto accomplished this by shifting the analysis away from any kind of social calculation and focusing on the choices people actually make.

We are, hence, led to define a position of maximum ophelimity<sup>5</sup> as one where it is impossible to make a small change of any sort such that the ophelimities of all individuals with the exception of those that remain constant, are either all increased or all diminished.<sup>6</sup>

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2 F. A. HAYEK: *The Constitution of Liberty*, Chicago 1960, pp. 205-206.

3 L. L. FULLER: *The Morality of Law*, New Haven, rev. ed. 1969, pp. 33-94.

4 See his major work – M. OAKESHOTT, *On Human Conduct*, Oxford 1975 – for a full account of this theory and his later and more accessible restatement in M. OAKESHOTT: "The Rule of Law", in: *On History and Other Essays*, Oxford 1983, ch. 2.

5 Ophelimity is Pareto's narrowed version of individual utility and is limited to satisfactions that have *economic* causes. Thus, the Pareto criterion was conceived as a measure of optimal ophelimity, the point at which people would be unwilling to make further moves to increase *economic* satisfactions.

6 For the complete text in English, see V. PARETO: *Manual of Political Economy*, transl. by A. S. Schwier,., ed. by A. S. Schwier and A. N. Page, New York, 1971,

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Public choice theorists, following Buchanan, emphasize an individualist interpretation of Pareto by assuming the given distribution and focusing on whether individual actors would choose voluntarily to make further exchanges. If not, the system is at an optimum, according to the values of its individual members – the only values which matter.

When Buchanan talks about Pareto optimality from this perspective, he clarifies that he is using the term in a "Wicksellian" contractarian framework.<sup>7</sup> By this he means that the exchange nexus is the most viable test for the unanimous consent of all interested parties and the best indicator of whether their welfare can be improved by any proposed trade or change, a notion he attributes to the nineteenth century economist Knut Wicksell. The difficulty faced by political economists who want to achieve Pareto efficiency in the social policy realm is that the unanimity that characterizes market exchanges is not readily imaginable as a feature of any process of social policy formation. But, if you follow the individualist assumptions of most economics and liberal political theory (social values do not exist apart from individual values) and assume that voluntary trade is proof of mutual gains, then "consensus or unanimity (mutuality of gain) is the only test which can insure that a change is beneficial."<sup>8</sup>

While the basic models of Pareto and Wicksell were indeed compatible and mutually supporting in most important respects, these two great turn-of-the-century social scientists were implacably opposed to one another.<sup>9</sup> It was Buchanan's genius that saw the essential similarity of their important insights and brought them together in his own work.<sup>10</sup> More recently, as his interpretation of Pareto has been challenged, Buchanan has tended to emphasize his dependence on Wicksell for the unanimity notion, speaking of the Pareto test "interpreted in Wicksellian terms."<sup>11</sup>

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Appendix, section 89. However, I have used here the translation of this passage published in R. CIRILLO: *The Economics of Vilfredo Pareto*, London 1979, p. 43.

7 J. M. BUCHANAN: *Liberty, Market and State: Political Economy in the 1980s*, New York 1985, pp. 264, 270.

8 BUCHANAN, "Positive Economics", p. 137.

9 P. HENNIPMAN: "Wicksell and Pareto: Their Relationship in the Theory of Public Finance", *History of Political Economy*, 14 (1982), pp. 37-64.

10 See R. E. WAGNER: "The Calculus of Consent: A Wicksellian Perspective", *Public Choice*, 56 (1988), pp. 153-166.

11 BUCHANAN: *Liberty, Market, and State*, pp. 164-165, 270.

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Buchanan looks back to Knut Wicksell, not only for the insight that unanimity is the correct ideal for social decision-making, but also for the recognition that some procedure for achieving approximate unanimity is necessary in the real world. While there may be a course all reasonable men would agree to, not all men will be reasonable all the time. This forces Wicksell (and Buchanan) into vague compromise positions, but does not drive them to anything like simple majority rule, which Buchanan and his co-authors have criticized so effectively:<sup>12</sup>

"Here the absolute unanimity rule must be broken; the political economist must try, as best he can, to judge the extent of unanimity required to verify (not refute) his hypothesis. Some less definitive rule of relative unanimity must be substituted for full agreement, as Wicksell recognized and suggested."<sup>13</sup>

In 1959 this logic drove Buchanan to endorse the principle of compensation to ensure consensus. Wicksell had previously advanced the idea that tax levies and national budgets should require parliamentary super-majorities of 75 - 90 percent.<sup>14</sup> Buchanan's later work with Gordon Tullock and others demonstrates his full awareness and concern for the problems of less-than-unanimous decision making. But to this day, he (like Wicksell) sees the political problem of achieving Pareto efficiency as a direct parallel of market efficiency, and focuses on models of political *exchange* as the means by which some form of unanimity or near-unanimity can be achieved. Comparing Wicksell's "contractarian framework" to the "quasi-utilitarian framework of orthodox welfare economics," Buchanan understands the Wicksellian approach and its emphasis on unanimity as "a straightforward extension of the exchange nexus."<sup>15</sup> As I explain below and elsewhere, a less direct anal-

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12 See J. M. BUCHANAN AND G. TULLOCK: *The Calculus of Consent: Logical Foundations of Constitutional Democracy*, Ann Arbor 1962.

13 BUCHANAN, "Positive Economics", p. 135.

14 KNUT WICKSELL: *Finanztheoretische Untersuchungen nebst Darstellung und Kritik des Steuerwesens Schwedens*, Jena 1896. See the long excerpt from the second essay, translated by J. M. BUCHANAN and published as "A New Principle of Just Taxation", in: R. A. MUSGRAVE AND A. T. PEACOCK (Eds.): *Classics in the Theory of Public Finance*, London and New York, 1958. Also see commentary in HENNIPMAN: "Wicksell and Pareto", p. 44 and WAGNER: "The Calculus of Consent: A Wicksellian Perspective", pp. 161-162.

15 BUCHANAN: *Liberty, Market, and State*, p. 270.

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ogy in the political and legal realms may provide a more natural and less strained solution.<sup>16</sup>

### 1. Using the Pareto Criterion in Welfare Economics

In his 1959 *entrée* to these matters, Buchanan showed that whereas welfare economists "have generally assumed omniscience in the observer," this necessarily means that the observer must rely on "*his own estimate of his subjects' value scales*," rather than their actual values in making policy recommendations.<sup>17</sup> This is unavoidable because the subjects' values are only revealed in actual choices and cannot be known in advance by anyone. Because ethical evaluations are necessarily introduced by the observer in this process, each variation of this approach "constitutes a distortion of the Pareto rule."<sup>18</sup> To maintain social efficiency in the true Paretian spirit, we must look not at the good or bad health (measured by some external value) of the political system, but rather to the level of "agreement" in the system.

"The political behavior of individuals, not market performance or results, provides the criteria for testing hypotheses of political economy."<sup>19</sup>

This analysis led Buchanan to conclude that a true application of Pareto's efficiency criterion to social policy changes would require compensation to losers. No one can be made worse off, and agreement is the only acceptable measure of welfare so understood. "'Welfare' is defined as that which is expressed by individual preference as revealed in behavior."<sup>20</sup> Buchanan saw his insistence on the compensation device as another way of defending "the classical liberal conception of democracy itself."<sup>21</sup>

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16 See N. B. REYNOLDS: "The Ethical Foundations of Constitutional Order: A Conventionalist Perspective", *Constitutional Political Economy*, 4 (1993), pp. 79-95.

17 BUCHANAN, "Positive Economics", p. 126.

18 "Positive Economics", p. 129.

19 "Positive Economics", p. 128.

20 "Positive Economics", p. 130.

21 "Positive Economics", p. 131.

## 2. Unanimity in Political Economy

Three years after his first article on the topic, James Buchanan took up Pareto optimality and its political implications once again in the context of a critique of the way welfare economists were misusing the idea.<sup>22</sup> He again objected to the inevitable intrusion of "social value judgments" or "social welfare functions" by those who wanted to use the Pareto criterion to classify results (1962: 341).<sup>23</sup> Going beyond his 1959 discussion of a compensation principle, he argued that "the criterion must be extended to classify social rules which constrain the private individual behavior."<sup>24</sup>

Buchanan developed this point by distinguishing between the choices of particular economic outcomes (results) in a society and the choices of frameworks of rules within which people make the decisions that produce those outcomes. While welfare economists tend to use the Pareto criterion to evaluate and predict outcomes, their proposals are always in terms of policy or changes in the governing body of rules. So the true relevance of the Pareto criterion for welfare economics is in the analysis of alternative sets of rules, not results. To demonstrate this point, Buchanan provides us with straightforward examples in which standard evaluation of results indicates sub-optimal situations by Pareto standards while the rules generating the situations may themselves be optimal in that there may be no way of

"securing [voluntary] consensus on any change. Thus, the mere demonstration of some violation of Pareto optimality in the orthodox classification of *results* may not be sufficient to suggest that some change in *policy* is dictated."<sup>25</sup>

While it might seem that Buchanan's constant movement back and forth between discussions of changes "in policy," "in the constitutional structure,"

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22 See J. M. BUCHANAN: "The Relevance of Pareto Optimality", *The Journal of Conflict Resolution*, 6 (1962), pp. 341-354. Republished in J. M. BUCHANAN: *Freedom in Constitutional Contract: Perspectives of a Political Economist*, College Station 1977, pp. 215-234.

23 See "Relevance of Pareto Optimality", p. 341. Buchanan's interpretation of the way the Pareto criterion has been used by welfare economists is reinforced by Renato Cirillo's review of this history, though Cirillo appears more sympathetic to the people Buchanan criticizes. See CIRILLO: *Economics of Vilfredo Pareto*, pp. 42-60.

24 "Relevance of Pareto Optimality", p. 341.

25 "Relevance of Pareto Optimality", p. 350.



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or "in the 'social constitution'" erases any significant differences between these, the conflation actually helps reveal the basic logic of his position. All choice and action take place within a situation structured and bounded by different kinds of rules. The particular hierarchy of rules does not matter so much for this analysis. The entire package of policies, rules, and constitutional provisions defines the region of private action, the results of which can be assessed by welfare economists for Pareto optimality. But the more important question that Buchanan has identified is whether the rules defining those regions are themselves optimal. And the test he proposes, following the pure logic of Pareto optimality, is unanimity:

"If a presumed or apparent nonoptimal rule cannot be changed through agreement among members of the group, the hypothesis stating that the rule is nonoptimal is effectively refuted."<sup>26</sup>

And,

"All possible changes in the constitutional structure become admissible so long as these rules changes may, conceptually, be approved by general agreement. The unanimity principle for changes in the 'social constitution' provides the only appropriate facultative constraint."<sup>27</sup>

Though I fully endorse Buchanan's shifting to a focus on the rules which define the situation in which economic choices are made, it seems to me that his attempt to apply the Pareto criterion to the choosing of rules cannot work. It is a move that arises from Buchanan's assumption that the process of constitutional choice is best understood as a process of exchange – like a market. But it overlooks the fundamental difference in that the unanimity he admires in market choosing never requires everyone in the society to agree with everyone else consciously and explicitly. It is a *de facto* unanimity which results when the myriad of economic exchanges between individuals are all voluntary. But this is a special kind of agreement, and certainly does not imply that everyone agreed before the fact that the actual state of affairs was to be desired or chosen by the group. That kind of agreement would never be possible in markets either. But social choices about rules are of this kind. When we choose rules, we choose to redefine the situation of all future activity for everyone. It would seem that we have a problem of apples and oranges, and

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26 "Relevance of Pareto Optimality", p. 353.

27 "Relevance of Pareto Optimality", p. 354.

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the assumption that constitutional choice is reducible to an exchange process must be defended against our intuitive doubts. While no one will deny the existence of a process of political exchange, it is always aimed at achieving the required majorities, and not unanimity.

Of course, Buchanan does recognize the virtual impossibility of achieving actual unanimity in such matters and here introduces the concept of "the costs of reaching agreement." Rather than undergo such costs, "members of the group may decide, in the constitutional process, to accept the departures from Pareto-optimality that less-than-unanimity voting rules may produce."<sup>28</sup> But we may ask, will they decide this unanimously? The problem persists, possibly in an infinite regress. Any decision process that requires agreement across a society will run aground on the free rider problem. And any compromise with the unanimity requirement fails to preserve the justifying logic of the Pareto criterion.

It seems to me that Buchanan's instincts are exactly right in searching for the most important form of Pareto optimality in the rules of the legal society which define the space within which private action takes place. And he also has to be right in his insistence that as in market activity, unanimity in decision making is the appropriate index of optimality. What does not seem to work as well is the direct assumed parallel between the making of choices by market actors in their limited and self-chosen exchange situations, and social decision making which by its very nature involves every citizen and can hardly ever achieve unanimity.

It is precisely at this point that the conventionalist theory of law described below provides a standard which meets the requirements of Pareto optimality without compromising on social decision-making rules. The *rule of law* properly describes polities which implicitly regulate all rules changes and policy changes in such a way that *constructive unanimity* is preserved. Changes which satisfy the *principles of rule of law* can be seen as fully conventional, based only in agreement and not in coercion. And this amounts to a political-legal equivalent of the Pareto test in economics.

Wicksell was Buchanan's forerunner and inspiration in the effort to preserve the voluntary character of human society by bringing the standard of unanimity or "approximate unanimity" into the realm of constitutional choice. "Wicksell's theoretical interest was to articulate general constitutional principles to which a government must adhere if it is meaningfully to reflect

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28 "Relevance of Pareto Optimality", p. 352.

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the consent of the governed."<sup>29</sup> For this his work has been recognized by public choice theorist Richard Wagner as "the first effort at constitutional construction."<sup>30</sup>

### II. The Rule of Law in Political and Legal Theory

It is common in the century of legal positivism to think of law first as a means of social control. The implication is that some people are controlling others and maintaining order through the manipulation and enforcement of legal rules. On this view, the purposes of the rules are the purposes of those who have the power to manipulate others. The effectiveness or appropriateness of a legal system or of any particular legal rule will obviously be measured in terms of its contribution to this purpose. Positivists will tend to understand the *rule of law* as obedience to law or supremacy of law, without attendant notions of implicit limits on law itself. On this approach, rule of law comes off looking rather weak and useless, except for propaganda purposes, as it finally protects no one from anything.

A persistent counter tradition understands law as a function of social agreements designed to protect and facilitate the freedom of each citizen in the pursuit of his or her self-chosen ends. The law's purpose is to provide a neutral framework for social interaction and individual action that will facilitate cooperative behavior while protecting all from the arbitrary interference or control of others. Thinkers in this tradition have identified the *rule of law* with individual liberty and the devices or principles that protect individuals from governmental control or manipulation.

Positivist critics have taken this to be a poorly disguised assertion of an ideological view of law, whether it be libertarian or just liberal in a more classical sense. Admittedly, the defenders of this more substantial and limiting notion of rule of law frequently retreat to the self-evident value of individual liberty as a justification for their proposals. This does not satisfy critics who would like to see equality and other values given the same consideration. Nor does it satisfy those who believe a theory of law should not be tied to any particular ideological position.

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29 See WAGNER: "The *Calculus of Consent*: A Wicksellian Perspective", p. 163.

30 "The *Calculus of Consent*: A Wicksellian Perspective", p. 162.

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The inadequacy of either view, taken by itself, is generally recognized by contemporary legal theorists. Positivist theory has proven incapable of explaining our most persistent intuition about law, our sense of obligation to obey a rule just because it is valid law. But natural law theory has proven incapable of explaining law as a social fact, often independent of any moral principles. And our modern understanding of the origins and process of law tends to reduce much valid law to nothing more edifying than facts about who wanted and got what when.

### III. Law as Convention

The conventionalist theory of law preserves the basic insights of both these approaches. It advances a notion of rule of law derived from social fact rather than ideology, as required by positivists, while providing normative structure and limitation as required by value based approaches.<sup>31</sup> The beginning claim of this approach is that social situations in which parties are coerced to conform to a norm are categorially distinct from those in which individuals voluntarily coordinate their actions in mutual expectation of benefit. Though it is clear that lovers of liberty will champion the latter situation and despise the former, the claim that the two are factually distinguishable requires no moral evaluation. My theory of law derives from an articulation of the implicit structure of the voluntary alternative when it is expanded to include a whole society. I claim that law understood as an extension of human agreement is vastly different than law understood as a function of habit and coercion, and that the *rule of law* is the inherent and distinguishing characteristic of law understood as convention. Rule of law becomes the standard of voluntariness or conventionality by which rules and legal systems as a whole can be measured. Variations from this standard tend to the coercive model.

The basic criterion of voluntariness or conventionality is unanimity. This is a strong criterion, and becomes more complicated as the size of the group involved increases. The assumption is that what people will agree to unani-

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31 See N. B. REYNOLDS: "Law as Convention", *Ratio Juris*, 2 (March 1989), pp. 105-120. In "The Ethical Foundations of Constitutional Order" the implications of conventionalism for constitutional theory are also explored.

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mously is uncoerced. Presumably, people agree to a coordinated course of conduct with an expectation of realizing some benefit not otherwise attainable and with assurance that any risks involved are limited and worth taking. James M. Buchanan has helped us in his reflections on constitutional political economy to understand unanimity as the basic test for voluntariness.<sup>32</sup> Note that it is not necessary that parties to an agreement expect benefits to be equally distributed. Nor is it necessary that they see the object of their agreement as the ideal arrangement. They only need see it as their best option, all things considered.

The major claim of this theory is that law rests on a fundamental convention or agreement which creates the legal community and the authority to make rules binding on all community members. Contrary to some economic approaches, including Buchanan's, it does not claim that the foundations of political society can be adequately explained on an exchange or market model. The community of law substitutes authority for unanimous agreement as the grounding of the rules it produces. The power to make and enforce authoritative rules is assigned to public officials whose formal positions are in turn defined by law and are not occupied by personal right. Acting in these authoritative roles, public officials represent the entire community. To use their public offices for personal advantage would subvert both the offices and the law. Their official actions serve as substitutes for the unanimous agreement of the community as a whole. Seen in this way, constitutional requirements for different kinds of majorities do not aim at approximating unanimity. Rather, they are prudential devices designed to reduce the likelihood that the power granted to public authorities will become corrupted and misused – advancing the private interests of the public officials and using the lives the citizens for private advantage.

### **1. Constructive Unanimity and the Conditions of Conventionality**

The move from actual unanimity in social decision making to the establishment of legal authority merely recognizes the practical impossibility of achieving complete agreement on a day by day basis, as well as the temptation to hold out for inordinate concessions that the rule of unanimity creates for individuals. Conventionalism claims that it is rational, given the impossi-

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<sup>32</sup> See "Relevance of Pareto Optimality", pp. 345-347, and *Liberty, Market, and State*, p. 245.

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bility of achieving actual agreement on every rule that will necessarily affect all members of the society, to concede one's veto over such rules and agree to institutions of authority on certain conditions that will govern the future exercise of that authority. The creation of legal authority is by definition unanimous as such authority only exists for those who agree to it and choose to take advantage of its existence in their lives. Scholars who have studied the process of social agreement have noted a number of general characteristics of such agreements. I have elsewhere shown how these empirically identified characteristics of actual agreements can be generalized as a set of abstract conditions of agreement.

One of those conditions is that the authority be constrained by a standard of constructive unanimity, that is, that it be limited in its actions to creating and enforcing rules and procedures that all members of the society might reasonably have agreed to in advance. This is not a Rawlsian veil of ignorance. The assumption has to be that people knowing their actual preferences, values, needs, and abilities could reasonably have agreed to let standards be laid down by public officials. This notion of constructive or ad hoc unanimity suggests the following as implicit limits on all legal authority:

1. Rules cannot violate the deeply held moral and religious beliefs of citizens. To the extent that these are matters many people hold to be more important than anything else, it is not reasonable to expect them to put these at risk in agreements made with others to improve their situations in other respects. (This may limit the range of moral and religious views that can share a single legal system. But note that it is a negative restraint only and does not require complete moral and religious agreement. It does require religious liberty.)
2. Authoritative decisions cannot arbitrarily single out individuals or groups for particular penalties or benefits.
3. The authorities themselves, in their private role as citizens and in their public roles as magistrates, are subject to all the rules they create.
4. There can only be one set of rules for everyone. There can be no special (privileged) categories of citizens.
5. Rules cannot be changed after the fact or made retroactive in their application without the actual consent of all concerned or compensation to those negatively affected.

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6. All making and enforcement of rules must be knowable and observable by all citizens.
7. Every citizen must have reasonable access to the process by which the rules are formulated and administered.
8. Every citizen must have full opportunity to defend his case when accused of rule violations.

Other conditions of such social conventions could be listed. This short list includes some of the most important *conditions of conventionality*. The claim is that any social convention to be ruled by law implicitly holds these as limitations on the authorities it creates. These are not moral principles, but are conditions that protect constructive unanimity. It is reasonable to give up one's veto to an authority that can be expected to act within these limitations.

### 2. The Principles of the Rule of Law

The link between this kind of rational actor analysis and traditional natural law and rule of law theories is that most of these conditions of conventionality can be expressed in terms of the widely recognized principles of rule of law, particularly as these have been articulated by Hayek and Fuller. Elements 1 and 7 on this list have not ordinarily been recognized in rule of law discussions. The others are directly translatable into recognized rule of law principles as follows:

2. The principle of generality – all rules must be general in scope.
3. The principle of generality – the rules must apply to everyone.
4. The principle of equality – there cannot be more than one class of legal persons.
5. The principle of prospectivity – new rules can only apply to the future.
6. The principle of publicity – no secret rules or prosecutions are allowed.
8. The principle of due process – all prosecutions must follow established rules which give defendants and plaintiffs full opportunity to defend their actions and their interests.

On this analysis, the conditions of conventionality or constructive unanimity are equivalent to the principles of the rule of law. Rule of law is revealed as an implicit norm or standard for legal communities that understand law as agreement or convention rather than coercion or habit. Rule of law just means constructive unanimity or conventionality. This includes, but goes far

beyond the view that authority requires obedience to law. It also entails a broad set of implicit limits on all authority. Not just anything can be a law. There are implicit standards and limits in much the sense that natural lawyers have always wanted. But these standards are not derived from moral principles which may or may not be supported with consensus. Rather, they are derived from social facts, from individual choices made for whatever reasons people (who may be presumed to act according to their own moral convictions and interests) may have as they pursue what they consider to be important in their lives. Thus the theory claims to transcend the recognized impasse in legal theory by basing law in social fact, while identifying broad standards inherent in law.

#### **IV. Rule of Law and Pareto Optimality**

On the analysis developed here, rule of law, like Pareto optimality, is a regulative norm. In fact, rule of law may just be an extension of Pareto optimality into the legal sphere. This possibility is glimpsed by returning to the two person exchange or agreement on a rule of mutual conduct. At this level, a fully voluntary exchange is by definition Pareto optimal. But how do we extend this measure of voluntariness into a sphere where the choices are being made by some for all, especially given that most of the choices that are made in this way would have been opposed by at least some of the people who are bound to them? The notion of constructive unanimity carries us ahead to this level, which is necessary if these concepts are to be introduced into a theory of law. Using this extended notion of rule of law we can now assess choices made by authorities for the society in terms of "constructive unanimity." We can call a legal system conventional or voluntarist in a meaningful way that distinguishes it from other types of social organization that are not based in voluntary choice.

Pareto optimality works well for analyzing a market because individuals are making their own choices on a case by case basis. There are simply an infinite number of ad hoc adjustments that individuals can work out between themselves, which reflect nothing but unanimous choices, but which never require everyone to agree to any one thing. Private property and market exchange make it possible for individuals to act unilaterally without any need for securing the consensus of the society as a whole. But the law is a very



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different matter. For every rule must by definition be general, and this makes it the business of every citizen. Legal society is also more complex in that individuals delegate some of the most important choices in ways that virtually guarantee that some of the outcomes will not be what they would in fact have chosen. The notion of rule of law as developed here gives us a way of speaking of such situations *as if* individuals had voluntarily agreed to specific rules. This is important because we still want to distinguish between a political and legal system that is based in voluntariness and one that rests on coercion.

The relatedness of the two criteria is also emphasized by the interesting fact that while they are both social measurements or criteria, dealing with societies as a whole, neither one is holistic. Rather each measure focuses on individuals and measures aggregatively in a way that lets every individual count.

Attempts to use the Pareto criterion in legal analysis have tended toward contractual models. Again, the problem may be the complexity involved in maintaining the sense of the Pareto criterion when you move from the market situation of actual agreement between individuals and a legal society in which commitments are made by authorities. Another attempt to get around the limitations of the Pareto criterion in this context is the Kaldor-Hicks test which Posner and others have used to rationalize changes by making cost-benefit calculations and paying off long run losers. This procedure is intended to yield a kind of "constructive consent."

The emphasis in these models is on actual costs and benefits, which can only be calculated *ex post facto*. The rule of law model spelled out above provides a set of criteria that can be used at any point in time, and therefore are available prospectively.

Oddly enough, even though Pareto optimality turns out to be less abstract or more basic than rule of law, it is dependent on rule of law in the real world. There is little question that a legal system exhibiting rule of law greatly enhances the voluntary choices necessary for Pareto optimality to be realized. The market economy needs law as a precondition.

While the Pareto criterion is not usually thought of in terms of a set of general principles or conditions that people can look to in improving their societies, there are plenty of economists who believe there are general market principles which can profitably be observed by societies that wish to raise their levels of Pareto efficiency. To the extent they are correct, the Pareto criterion indirectly provides the kind of general guidance to free societies that

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rule of law offers. But neither imposes a universal or maximizing rule. Rather, each protects individuals as the only sources of value. It is from this perspective that it might be said that rule of law and Pareto optimality are the same thing. Each is a measure of the extent to which individuals in a society are able to use their lives for their own purposes, to pursue their self-chosen ends. The main difference is that the Pareto criterion focuses on distribution issues while rule of law focuses on the creation and administration of rules that govern all forms of individual conduct.

## 18 An Invisible Hand Theorem for Collectivists

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- I. Introduction
- II. The Central Theorem
- III. Imperfect and Incomplete Information
- IV. A Generalization Allowing for Ungrateful Future Decisionmakers
- V. Supplying Vital Institutions
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**PREFACE.** Although cloistered away for almost two decades now, out of communication with almost all of my old friends, I find no difficulty in recalling the lively, penetrating, and unique mind of Jim Buchanan. What most distinguished Jim to me was his appreciation for sensible novelty. The Jim I remember was quick to recognize the oppressive power of intellectual tradition and rebelled against it whenever it became clear that the tradition posed a substantial barrier to a rational understanding of the world around us. Along with this basic iconoclasm came an unusual appreciation for seeing old things in a new light. No matter how much an idea grated against his basic instincts, he appreciated an idea if it amounted to a logical and empirically meaningful attack on a traditional belief.

But the old Jim may have completely changed. I'd like to know if he has. If so, he will most likely *not* appreciate the following paper.

**ABSTRACT.** The "1st and 2nd Welfare Theorems of Economics" establish a basis for praising the free and narrowly rational decisions of individuals living under an idealized form of private property. This paper proves an analogous pair of theorems for collectivist worlds. An analogous application is to unconditionally praise the free decisions of the members of a non-conflictual team and to condemn any centralized attempt to interfere with these rational individual decisions.

The theorem is then generalized to admit a limited form of conflict, one in which subsequent decisionmakers do not appreciate the consumption decisions of their predecessors. This generalized form is most appropriately ap-

plied to intertemporal individual decisionmaking and an explanation of the observed lack of personal consumption commitments in stable informational environments.

The theorem and its generalization also apply to political decisions regarding vital institutions. In particular, the theoretical results predict that a group's objective equilibrium choices of its vital institutions, as well as being theoretically efficient, are made in an honest and nonpartisan fashion.

## I. Introduction

It is commonly observed that in non-conflictual interactions – i.e., when all of the individuals in a group share the same basic preference orderings over all of their alternative social states – individuals openly communicate. The team members behave neither deceptively nor aggressively toward others in the group. Even when the environment prevents some members of the group from making decisions with the same quality of information as others in that group, the former individuals are observed to willingly submit to the suggestions of a more informed coordinator, or informal "team leader."

These empirical regularities suggest that the theoretical outcome of narrowly rational, informed individual decisions in non-conflict interactions are always best for the group. In other words, if informed and non-conflicting individuals sequentially maximize, then they will always reach their commonly-desired optimum. The purpose of Section I of this paper is to prove this result, i.e., an invisible hand theorem for collectivists. Actually, it's a much more simple and robust theorem than the analogous theorem that holds for selfish individuals. For proving the two necessary parts of the selfish-individual theorem requires a whole load of additional, quite unrealistic, assumptions.

Yet the new invisible hand theorem has a similar, but much more extreme, laissez faire implication. In fact, it's anarchic. When you're part of a nonconflictual team, you shouldn't have to take any kind of orders from anyone! (Maybe suggestions, but no orders.) People who try to make and enforce rules for the team members (e.g., certain coaches) are fatuous power mongers or misguided paternalists. Such regulation can only interfere with the team's invisible hand and reduce social welfare. If you prize personal freedom, you should appreciate this theorem.

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More specifically, the purpose of Section I of this paper is to prove that, in non-conflictual interactions, narrowly rational individual actions under perfect information (a la von Stackelberg and von Neumann-Morgenstern): (1) always generate a solution, and (2) that solution is always a joint optimum. It would be peculiar if (2), our optimality result, which is the simple converse of Bellman's optimality principle, had not been proved elsewhere. We just haven't been able to find the theorem explicitly stated or proved elsewhere. Regarding (1), the existence result, we do find a way to avoid the indifference conundrums posed by Peleg and Yaari for perfect information games when later decisionmakers are indifferent between various solution points. (While Goldman has proved a fairly general existence result for these environments, the pre-existing literature still leaves us without an algorithm for resolving the Peleg-Yaari indifference conundrums.)

Section II of the paper shows how the optimality of a radically decentralized equilibrium extends over to imperfect and incomplete information cases, including those covered in the pioneering work on non-conflictual teams of Marshak and Radner.

Accepting the assumption of universal rationality, the combined existence and efficiency results can be used to test for the existence of conflict. In particular, if individuals are observed to act deceptively or aggressively toward one another, activities that definitionally subtract from the social total, the payoffs are not "team" payoffs. The theorem can be used, for example, to determine whether or not a single consumer – viewed as a sequence of distinct decisionmakers – represents a set of conflicting decisionmakers.

A long chain of economic theorists (Strotz, Pollack, Peleg-Yaari, Hammond, Thaler-Shefrin and several other, no-less-sophisticated, thinkers) have argued that our unconstrained future selves are likely to choose future consumption streams that differ from (or are "inconsistent with") the streams that our current selves would most prefer, and that the resulting conflict, an external diseconomy from future to present selves, leads current selves to make commitments constraining the behavior of future selves. However, the standard empirical examples of consumption-commitments – viz., joining Christmas clubs, avoiding vice-inducing situations (like Odysseus ordering himself tied to the mast), and hiring budget-enforcing agents – are *not* unambiguous examples of such constraints. Rather, a bit of introspection suggests that these are examples of constraints imposed on future selves that are *less informed*, impulse-buying, selves than the current, more thoughtful, self. The literature's inability to isolate clean examples of such consumptive "time

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inconsistencies" speaks for a genuine empirical rarity of intrapersonal consumption externalities from informed future selves to informed present selves.

We can thus take the absence of consumption commitments in situations where the individuals are continually well-informed to imply an absence of consumption externalities from future selves to current selves. A person's informed future consumption choices do *not* displease the person's informed current self. But an absence of commitments does not imply a complete absence of conflict. Current selves may still impose externalities on, or do things that displease, their future selves. Section III of this paper correspondingly shows that, under perfect information, a no-commitment solution under this limited form of conflict remains optimal for the externality-imposing current decisionmaker. Viewing the current individual as the appropriate social target, the theorem – which generalizes a consistency theorem of Blackorby, Nissen, Primont, and Russell – is a generalization of our theorem to worlds with exclusively forward-looking, or "ungrateful", future decision-makers.

A generalization of these theorems allowing them to apply to certain political interactions is discussed in Section IV.

## II. The Central Theorem

A convenient description of the first non-conflict situation has the utilities of each of the individuals in a group represented by monotone increasing functions of a common, continuous, real-valued function of individual actions,  $f(x_1, \dots, x_n)$ , where the action,  $x_i$ , of the  $i^{\text{th}}$  individual,  $i = 1, \dots, n$ , is chosen from a compact set of feasible actions,  $X_i$ .

If the individuals in this situation independently (or simultaneously) chose their actions, each selecting an  $x_i$  that maximized  $f$  for given  $(x_1, \dots, x_{i-1}, x_{i+1}, \dots, x_n)$ , the resulting, Cournot-type, solution set might obviously contain many local maxima that are not global maxima. There would be nothing to guarantee the achievement of a globally maximal value of  $f$ . The source of the problem is that the decisionmakers have no information about one another's actions, and therefore there is no genuine "coordination" of their activities.

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To represent genuinely "coordinated," noncooperative decisionmaking, we first assume "perfect information" in the von Stackelberg-von Neumann-Morgenstern sense, meaning that the individuals choose their actions in sequence, where individual 1 chooses first and then, in full knowledge of this move, individual 2 chooses an action. This continues on until the  $n^{\text{th}}$  individual chooses an action  $x_n$  in  $X_n$  that maximizes  $f(x_1, \dots, x_{n-1}, x_n)$  for the known, previously chosen, values of  $x_1, \dots, x_{n-1}$ . We first show that a pure-strategy solution to the above game always exists.

The existence of an optimal  $x_n$  for the last mover is assured by the compactness of  $X_n$  and the continuity of  $f$  (for a proof, see Apostol, p. 73). There may be several such maximizing values of  $x_n$ . We shall let  $x_n^*(x_1, \dots, x_{n-1})$  represent  $n$ 's solution correspondence. Since  $x_n^*$  is going to be so picked, individual  $n-1$  will attempt to pick an  $x_{n-1}$  that maximizes, for given  $x_1, \dots, x_{n-2}$ , the function  $f(x_1, \dots, x_{n-2}, x_{n-1}, x_n^*(x_1, \dots, x_{n-2}, x_{n-1}))$ . Since the value of  $f$  for a given  $x_{n-1}$  is the same regardless of the value of  $x_n$  subsequently chosen from the non-empty image set of  $x_n^*(x_1, \dots, x_{n-1})$ , the actual choice by  $n$  from this set is a matter of indifference to  $n-1$  as well as to  $n$  and therefore does not affect the choice by  $n-1$ . Momentarily assuming the existence of a maximizing solution for individual  $n-1$ , an assumption validated in the next paragraph, the maximization yields another non-empty correspondence,  $x_{n-1}^*(x_1, \dots, x_{n-2})$ . Similarly, individual  $n-2$  attempts to pick, prior to the choices of  $n-1$  and  $n$ , an  $x_{n-2}$  that will maximize, given the inherited  $x_1, \dots, x_{n-3}$ ,

$f(x_1, \dots, x_{n-3}, x_{n-2}, x_{n-1}^*(x_1, \dots, x_{n-3}, x_{n-2}, x_n^*(x_1, \dots, x_{n-3}, x_{n-2}, x_{n-1}^*(x_1, \dots, x_{n-3}, x_{n-2}))))$ . A solution set to this sequence of  $n$  maximizations,  $x^*$ , may, of course, contain several elements.

To prove that the set is non-empty, it is sufficient to prove that the above-described response correspondences,  $x_{n-1}^*(\cdot), \dots, x_1^*(\cdot)$ , are all non-empty. Again,  $x_{n-1}^*(\cdot)$  is non-empty if the domain of the objective function variables controlled by  $n-1$  (i.e.,  $(x_{n-1}, x_n^*(x_{n-1}))$ ) is compact (Apostol, *ibid*). Since the domain of  $x_{n-1}, X_{n-1}$ , is compact by assumption, we need only show that the

range of  $x_n^*(x_{n-1})$ , or  $\bigcup_{x_{n-1} \in X_{n-1}} x_n^*(x_{n-1})$ , is compact. This is done in three

steps: First, because  $(x_{n-1}, x_n^*(x_{n-1}))$  maximizes a continuous, real-valued objective function for a given  $x_{n-1}$ , we know that  $x_n^*(x_{n-1})$  is upper-semicontinuous (Berge). Second,  $x_n^*(x_{n-1})$  is closed for any given value of  $x_{n-1}$ . For suppose otherwise; then the set  $x_n^*(x_{n-1})$  would not contain all of its limit points. Call one of these excluded limit points  $z$ . Since  $X_n$  is closed,  $z \in X_n$ . And since  $z$  is

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not in  $x_n^*(x_{n-1})$ ,  $f(x_1, \dots, x_{n-1}, z) < f(x_1, \dots, x_{n-1}, x_n^*(x_{n-1}))$ . From these facts, it would follow that  $\lim_{x_n^y \rightarrow z} f(x_1, \dots, x_{n-1}, x_n, v(x_{n-1})) > f(x_1, \dots, x_{n-1}, z)$ , which contradicts the

continuity of  $f$ . So  $x_n^*(x_{n-1})$  is an upper-semicontinuous function with a closed image for any given  $x_{n-1}$ . We can now complete the proof by applying the result of Nikaido (Lemma 4.5), stating that such a function defined over a

compact set produces a total image set, our  $\bigcup_{x_{n-1} \in X_n} x_n^*(x_{n-1})$ , which is compact.

So  $x_{n-1}^*(x_1, \dots, x_{n-2})$  is non-empty. The same procedure can be repeated to show that  $x_{n-2}^*(x_1, \dots, x_{n-2})$  is non-empty, etc.

This completes our existence proof. We are now prepared to discuss optimality.

In general, that is, when conflict may be present, perfect information solutions are not generally jointly efficient. Standard Prisoner's Dilemma games illustrate this simple fact. But we are dealing here with a non-conflict situation, where the possible payoffs do not permit the redistributive opportunities presented in a standard Prisoner's Dilemma game.<sup>1</sup>

We now prove that a perfect information solution will always achieve a joint optimum in the above, non-conflict situation:

Suppose that a member of the solution set, say  $x^*$ , were not a global maximum point. Then there would be an alternative  $x^o \in X = \prod_{i=1}^n X_i$ , such that

$f(x^o) > f(x^*)$ . Had individual  $n$  been presented with  $x_{1,0}, \dots, x_{n,0,1}$ , the individual would have picked  $x_{n,0}$  (i.e.,  $x_n^*(x_{1,0}, \dots, x_{n-1,0}) = x_{n,0}$ ); and  $x^o$  would have resulted instead of  $x^*$ . It follows that  $n$  was not presented with  $(x_{1,0}, \dots, x_{n-1,0})$ . It similarly follows that if individual  $n-1$  had been presented with  $x_{1,0}, \dots, x_{n-2,0}$ , the individual would have picked  $x_{n-1,0}$ ; for  $x_n^*(x_{1,0}, \dots, x_{n-1,0}) = x_{n,0}$  and  $f(x^o) > f(x^*)$ . So  $n-1$  was not presented with  $x_{1,0}, \dots, x_{n,0,2}$ . For the same reason, individual  $n-2$  was not presented with  $x_{1,0}, \dots, x_{n,0,3}$ , and so on, up to individual

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1 An additional, well-known difficulty with perfect information solutions is that when a later mover is indifferent between several possible actions, prior movers – not knowing which among the later mover's indifferent actions will actually be selected – do not really know what to do. This difficulty also disappears in non-conflict situations because, as we have already indicated, when prior movers always share the indifference of later ones, the particular actions of later movers within their solution correspondences have no effect on the utilities or decisions of prior movers.



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1. But individual 1 has no excuse. Individual 1 must have not maximized utility. For, according to the above sequence, wherein  $x^* \dots x^0$  implies  $x_1^* \dots x_1^0$ , if individual 1 had picked  $x_1^* = x_1^0$ , then the outcome would have equalled  $x^0$  and individual 1's utility would have been higher. So the supposition that  $x^*$  is not a global maximum contradicts the assumption of individually rational choice. The solution point  $x^*$  must be a global maximum.

Jim Mirrlees has privately suggested an alternative, more direct, optimality proof. It can be paraphrased as follows: Pick any  $x$ . Then change  $x_n$  so that it maximizes  $f$  for the given  $x_1, \dots, x_{n-1}$ . The resulting  $f$  defines a particular value of a function,  $f_{n-1}[x_1, \dots, x_{n-1}]$ . Then pick an  $x_{n-1}$  that maximizes the latter function, thus yielding an  $f$  that defines  $f_{n-2}[x_1, \dots, x_{n-2}]$ , etc. By definition,  $f_1 \geq f_2[x_1] \geq \dots \geq f_{n-1}[x_1, \dots, x_{n-1}] \geq f[x_1, \dots, x_n]$ . Since  $f_1$  depends on no variables, it is, according to Mirrlees, unique and therefore the same regardless of what value of  $x$  we initially chose. In particular, if

$$x = x^0, f_1 = f_2 = \dots = f_{n-1} = f(x^0) = \max_x f(x_1, \dots, x_n).$$

So  $f_1$  is our maximum and the theorem is proved.

Maxim Engers has pointed out that the optimality theorem leads to a simple alternative, albeit less direct, existence proof: Since the converse of this optimality theorem, Bellman's Optimality Principle, also holds, a sequential maximization solution is *equivalent* to a maximum. Therefore, since a maximum in our model exists, so does a sequential maximization solution. Unfortunately, this existence proof does not extend to the generalized problem of Section III while our more cumbersome, direct, proof does.

### III. Imperfect and Incomplete Information

The above results are derived for complete and perfect information environments, where each decisionmaker has the same information as the others as regards the common objective function and, in addition, knows the prior actions of the past decisionmakers as well as the information that will be available to future decisionmakers. Nevertheless, our optimality conclusion extends over to incomplete and substantially imperfect information environments. For example, regarding the correctable coordination failures described in Marschak and Radner's pioneering study of "teams" (our "non-conflictual

teams") of imperfectly informed individuals, such teams actually have no reason to benefit from the central command structures introduced by these authors (*cf.*, *ibid.*, pp. 312-313). When, for example, the social payoff is increased by revising the order of moves, the individuals (ex-commanders) who see the problem will find no rational resistance to their necessarily prior actions *suggesting* a revised order of moves. The same is true for actions in which more informed individuals share their information with others or advise others of their correct moves. Their information or advice can be completely trusted by the others. In other words, any communication or proposal that would better coordinate the decentralized decisions of the incompletely or imperfectly informed individuals would itself describe a rational action in a more general, yet-still-radically-decentralized, team equilibrium.

#### IV. A Generalization Allowing for Ungrateful Future Decisionmakers

As noted in the Introduction, the absence of incentives to devote resources gaining transfers from others implied in the above non-conflict situation continues to hold under a weakening of the conditions on preferences. In particular, it continues to hold as long as each future decisionmaker has the same preferences *over future actions* as the immediately preceding decisionmaker. In this case, the successive objective functions are:

$$\begin{aligned} f_1(x) &= U_1(x_1, f_2(x)) \\ f_2(x) &= U_2(x_1, x_2, f_3(x)) \\ &\cdot \\ &\cdot \\ f_{n-1}(x) &= U_{n-1}(x_1, \dots, x_{n-2}, x_{n-1}, f_n(x)) \\ f_n(x) &= U_n(x_1, \dots, x_{n-1}, x_n), \end{aligned}$$

where  $f_{i+1}' > f_{i+1}'' \geq U_i(x_1, \dots, x_i, f_{i+1}') > U_i(x_1, \dots, x_i, f_{i+1}'')$ . Thus, for any given  $x_1, \dots, x_i$ , the  $i^{\text{th}}$  individual's objective function is a monotone increasing function of the  $i + 1^{\text{st}}$  individual's function.

A particular perfect information solution,  $x^*$ , is, as above, an  $x$  such that  $x_n^*$  is picked so as to maximize  $f_n(x)$ ;  $x_{n-1}^*$  is picked so as to maximize  $f_{n-1}(x)$  given  $x_1, \dots, x_{n-2}$  and the dependence of  $x_n^*$  or  $x_{n-1}^*$ , etc. The existence of a solu-

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tion holds under the same conditions on preferences, and through the same argument, as in the direct proof of Section I; the exercise will not be repeated.

What we wish to show is that no decisionmaker has an incentive to influence later decisionmakers, i.e., that all subsequent decisionmakers will choose a sequence of actions that maximizes the utility of a current decisionmaker. From this it follows that a current decisionmaker has no incentive to threaten to punish, or withhold information from, future decisionmakers.

The result holds trivially for  $i = n$ . To show it for  $i = n-1$ , first note that our above specification on the forms of the successive objective functions implies that any  $x_n$  that maximizes  $f_n$  given  $x_1, \dots, x_{n-1}$  will also maximize  $f_{n-1}$  given  $x_1, \dots, x_{n-1}$ . Therefore,  $n$  will choose the  $x_n$  that maximizes the utility of  $n-1$ , say  $n$ 's mother, as long as any pair of actions resulting from  $n-1$ 's first rationally picking an  $x_{n-1}$  in anticipation of her own subsequent utility-maximizing choice of an  $x_n$  – call the pair  $x_{n-1}, x_n$  – unconditionally maximizes her utility,  $f_{n-1}(x_1^*, \dots, x_{n-2}^*, x_{n-1}, x_n)$  over all  $x_{n-1}, x_n$  in  $X_{n-1} \times X_n$ . Theorem 1 – that rational, perfectly informed, sequential choice under a common utility function achieves an unconditional maximum of that function, tells us that  $x_{n-1}, x_n$  does indeed unconditionally maximize  $f_{n-1}(x_1^*, \dots, x_{n-2}^*, x_{n-1}, x_n)$ . Building on this, we can show in the same way that  $x_{n-2}, x_{n-1}, x_n$  unconditionally maximizes  $f_{n-2}(x_1^*, \dots, x_{n-3}^*, x_{n-2}, x_{n-1}, x_n)$ , and so on until we arrive at individual 1, at which point our theorem is proved.

## V. Supplying Vital Institutions

In ordinary human societies, where the earlier decisionmakers are much more selfish than in the above models, the basic object of rational choice, as emphasized in Thompson-Faith, is the reaction function. What we have been calling "rational", or "narrowly rational", choice would then apply to a choice among alternative reaction functions.

In particular, once the rent-determining reaction functions that define the society are established, the joint-survival-determining reaction-functional choices necessary for the defense of these societies are not the subject of internal conflictual interaction. Thus, once the initial distributional issues are settled, there should be no disagreement among equally informed individuals on the existence, for example, of a continued armed response to an attack, its method of finance, an intermediate military hierarchy, and so on. Abstracting

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again from honest disagreements, the political and military decisions that set up such non-controversial institutions should therefore possess the same lack of deception and inter-personal aggressiveness – the same lack of rent-seeking when interpreting these activities in a social context – that exists in the above model.

In other words, equilibrium social decisions as regards various vital institutions, besides being efficient, are made in an honest and non-partisan fashion. Moreover, applying our generalized theorem (Section III above), the vital military obligations that current political decisionmakers impose on their future selves must be similarly regarded as efficient obligations despite the possible disagreement of the future decisionmakers.

Unlike the other applications, some commitments are essential. If the announced responses to foreign aggression are not substantially carried out, if the announcements are hollow threats, the shared social surplus will be lost. Nevertheless, an individual may easily feel better-off as a probably-live coward than a probably-dead hero; and even the whole society may easily feel "better red than dead" or that war debts are negotiable. Aggression against cowards, and conflict at the onset of a war or over the payment of war debts, are thus inevitable. The non-conflictual interaction, and hence the theory of this Section, must therefore be carefully restricted to the strictly *pre-war* setting in which *defense institutions* are being established.

Hence, the test should come during peacetime, especially during military preparation. One such test is the absence of ordinary rent-seeking, or "partisan", politics in choosing to adopt a set of collectively vital defense institutions.

## VI. A Final Suggestion

For almost two centuries now, our universities have featured an artificial economic debate between individuals extolling the virtues of free markets and those extolling the virtues of utopian socialism. Even a cursory reading of the influential authors – including Professor Buchanan – informs us that the former are actually extolling the virtues of free markets *only* where people are not significantly benevolent (e.g., in Adam Smith's butcher shop) and that the latter [utopians are not Marxists] are extolling the virtues of anarchic

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socialism *only* where people are highly benevolent toward one another (e.g., in a Christian monastery).

These entertaining debaters should drop the pretense and merge. Both, now, have an invisible hand theorem to support their policy positions. There is as much logic to support one position as there is to support the other. There are areas of an economy in which pure benevolence (where individuals share the same payoff function) is a useful assumption and other areas where benevolence can be totally ignored. And neither school has much to say about models containing intermediate levels of benevolence. There is just no obvious reason for these two schools to disagree with one another.

More importantly, the two schools of thought (now that both are theoretically supported) share a common policy implication. Suppose, as members of both schools appear to believe that the elites of almost any society use their influence over education to grab a substantial and unjustified amount of administrative authority over others. The two schools' respective invisible hand theorems then tell us that otherwise efficiently structured societies will be observed to suffer from: (1) the regulation of competitive markets that are devoid of externalities, and (2) the enforcement of rules against specific members of teams that possess no internal conflict. The two forms of evidence are quite complementary. And if evidence regarding one implication is prohibitively costly to produce, evidence supporting the other implication would lend substantial credence to their shared social hypothesis.

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## **Part IV**

# **Public Choice and Public Policy**

# 19 Does Abstention Matter? <sup>1</sup>

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- I. The Model
  - 1. No Abstention, No Discrimination
  - 2. Abstention and Discrimination Permitted
- II. Remarks

**Does Abstention Matter?** A significant portion of James Buchanan's academic career has been devoted to the study and design of constraints that limit the power of government.<sup>2</sup> Some of the studies deal with political constraints such as constitutional limits to taxation.<sup>3</sup> Others deal with market-based constraints in which citizens' ability to "vote with their feet", even to secede, limits the ability of government to redistribute wealth. For example in Buchanan and Faith (1987), the government is constrained in its ability to expropriate resources from the citizenry by the possibility of secession. The lower the cost to secessionists of setting up a new government, the larger the size of the seceding group, the smaller the tax base in the original jurisdiction, and the lower the government's tax rate. The more difficult is secession the higher are tax rates.

The current paper considers a different form of government exploitation, discriminatory benefits. Assuming a representative democracy, what limits the ability of an elected representative to discriminate in the allocation of benefits against constituents who abstain from voting? For example, suppose that a certain subgroup population is observed not to vote in the general elec-

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1 One of my fondest memories of when Jim Buchanan and I were colleagues in Blacksburg was when we would sit in his office talking. The conversation would begin with the weather, or the state of our vegetable gardens, and somehow an interesting idea would emerge and begin to take root. Eventually, one of us would go off and write something up, show it to the other person, and the whole process would start up again until we either gave up or had a completed paper. The present paper began in dialog with my colleague Hector Chade. This is the first "write-up".

2 See the various articles in BUCHANAN (1989).

3 See, for example, BRENNAN AND BUCHANAN (1980).



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tion for representatives. Would non-voters be expected to receive a smaller share of government benefits than voters receive? After all, why would a representative work to produce benefits for constituents that have aren't going to vote against you? Does abstention matter?

This paper outlines a very preliminary model of government discrimination under voting with the possibility of abstention. Although quite simplistic, the model suggested here seems capable of generating implications with respect to the level and distribution of government benefits within legislative districts.

## I. The Model

A legislative district consists of  $N$  voters and one elected representative. The representative seeks to maximize his utility, which depends on two arguments, leisure and the sized of his vote margin in the election. The number of votes received depends upon the quantity of government benefits consumed by each voter.<sup>4</sup> The quantity of government benefits depends positively on the amount of effort that the representative devotes to the legislative process. The more time the representative spends securing output for his constituents the less leisure he consumes.

Given the level of output provided by the representative, each voter decides whether or not to vote in the next election. And if the voter decides to participate, how to vote. The decision to vote depends on the degree of voter satisfaction with respect to the voter's consumption of government benefits, the value of a default level of benefits if the representative is not re-elected, and the cost of voting. How one votes, given one does vote, depends on the whether the voter is better off under the representative's or the default level of benefits. Given that there is a cost to voting, those who abstain are not necessarily disgruntled citizens unimpressed by either the representative's or the alternative level of benefits.

We will consider two environments. In the first, voting is costless, and all voters receive an equal quantity of government benefits. There is no abstention, and there is no discrimination. In the second environment, voting is

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4 We ignore taxes. Alternatively we could simply assume that the cost of governmentally provided benefits is distributed uniformly across all voters.

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costly and voters are free to participate or not participate in the election of their representative. The representative can supply different levels of benefits to different voters.

### 1. No Abstention, No Discrimination

The number of favorable votes that the representative receives in his next election is a function of the quantity of government benefits consumed by each of the  $N$  voters in the representative's district. Let  $x^i$ ,  $i=1, \dots, N$ , denote the level of government benefits received by voter  $i$ . Assume that benefits are a pure public good, so  $x^i = X$ , where  $X$  is the total level of benefits provided by the representative. If the representative is re-elected, he will continue to provide  $X$ . If defeated, the default level of benefits,  $X^a$ , will be provided.

Each voter has a most preferred, or ideal, quantity of government benefits, denoted  $Z^i$ . Assuming voter preferences are single-peaked given by  $i$ 's preferences, which we assume are single-peaked, voter  $i$  will vote for (against) the representative if  $|X - Z^i| < (>) |X^a - Z^i|$ . Let  $f(X)$  be the distribution of ideal points and  $F(X)$  its cumulative density function. The median of  $f(X)$  is denoted  $Z_{med}$ . If  $X < X^a$ , then the number of voters who prefer  $X$  to  $X^a$ ,  $n$ , equals  $F((X^a+X)/2)$ , and  $N - F((X^a+X)/2)$ , equals the number of voters who prefer  $X^a$  to  $X$ . If  $X > X^a$ , then the number of voters who prefer  $X^a$  to  $X$  equals  $N - F((X^a+X)/2)$ , and the number of non-supporters equals  $F((X^a+X)/2)$ .

The representative's utility function,  $U(L, V)$ , depends on leisure ( $L$ ) measured in units of time and the vote margin in the next election ( $V$ ). We assume that  $U$  is an increasing, concave function of  $L$  and  $V$ . The representative produces  $X$  for his constituents by allocating some fraction of his time endowment  $T$  to the legislative process. The more time spent proposing, lobbying other representatives, and so on, the more benefits the representative can deliver to his constituents. The total time cost of producing  $X$  is  $C(X)$  with  $C' > 0$ .

The representative's problem is to maximize  $U(L, V)$ , by choice of  $X$ , subject to the time constraint,  $T = L + C(X)$ , and the condition that he is re-elected ( $n \geq \frac{1}{2}$ ). If  $X^a \leq Z_{med}$ , the representative will choose an  $X$  arbitrarily close to (but larger than)  $X^a$ . Any  $X < X^a$  will fail to satisfy the re-election constraint, and for  $X = X^a + \epsilon$ ,  $\epsilon > 0$ , the number of votes is less than at  $X = X^a$ . If  $X^a > Z_{med}$ , any choice of  $X$  greater than  $Z_{med}$  but less than  $X^a$  satisfies the re-election constraint. Limiting the choice of  $X$  to this range of values, the

representative's time constraint becomes relevant. So, recalling that  $n = F([X^a + X]/2)$ , then  $V = 2F([X^a + X]/2) - N$ . Substituting  $V$  into  $U$ , the first-order conditions imply that  $(\partial U/\partial L) C' = (\partial U/\partial V) (\partial F/\partial X)$ , or  $(U_V/U_L) F' = C'$ . So, in general, the representative chooses a benefit level less than the vote-maximizing level.

## 2. Abstention and Discrimination Permitted

Assume now that discrimination in the provision of government benefits is possible and that voting is costly. Thus, voters can abstain.<sup>5</sup> The possibility of discrimination requires the representative to make two decisions: how many total benefits to provide, and to allocate them across voters. The possibility of costly voting requires that more assumptions be made regarding the act voting.

Rather than partake in the debate on instrumental versus expressive voting, we shall simply assume that an individual votes when the expressive benefits from voting exceed the cost of voting. However, we also assume that the expressive benefits are an increasing function of the absolute difference in the benefits between consuming  $x$  and the pure public good  $X^a$ . In particular, voter  $i$  will vote if and only if  $B(|x^i - X^a|) \geq k^i$ , where  $B^i$  ( $B^i > 0$ ), is  $i$ 's expressive value of voting function, and  $k^i$  is  $i$ 's cost of voting. In addition, we assume that the *probability* that a person votes is an increasing function of  $(B^i - k^i)$ . So, the larger the absolute differences in utilities the greater the probability that the voter will vote (yea or nay). We shall denote the probability that voter  $i$  supports the representative in the next election given  $X^a$  by  $\phi^i(x, X^a, k^i)$ , and the probability that  $i$  votes against the representative by  $\gamma^i(x, X^a, k^i)$ .  $\phi^i$  is increasing in  $x$ , and decreasing in  $X^a$  and  $k$ , whereas  $\gamma^i$  is decreasing in  $x$  and  $k$ , and increasing in  $X^a$ . Because of the possibility of abstention,  $\phi^i + \gamma^i$  need not sum to one.

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5 MYERSON (1999) constructs a model of discrimination among benefit shares where voters are uncertain about the ability of the representative. The representative then signals her ability through the level of benefits she provides different groups of voters. Myerson shows that the equilibrium allocation of public benefits can be strongly discriminatory (all or nothing) or perfectly non-discriminatory, and the possibility of abstention doesn't affect the equilibrium allocation. Contrary to our model, voting is costless, and abstention occurs as a result of voters trying to avoid the "swing voter's curse".

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Given our description of voter choice, let there be two classes of voters, favored and non-favored. The  $n$  favored voters each receive a common level of benefits  $x$ , and the  $N-n$  non-favored voters no government benefits.<sup>6</sup> Because voting is probabilistic, the representative's utility depends on leisure and the expected vote margin,  $EV = \sum_{i=1}^n [\phi^i(x)] - \sum_{j=n+1}^N [\gamma^j(0)]$ . The representative can choose both size of the favored group  $n$  and the level of output  $X$ , where  $X = nx$ . The (risk-neutral) representative's problem is to maximize  $U(L, EV(X))$ , by choice of  $x$  and  $n$ , subject to  $EV$ , the budget constraint,  $T = L + nxc$ , where  $c$  is the (constant) marginal cost of providing  $x$ .

Assuming voters are identical, the first-order conditions to this maximization problem are:

$$-\partial U/\partial L(nc) + \partial U/\partial EV[\sum_{i=1}^n [\partial \phi^i/\partial x]] = 0, \text{ and} \quad (1)$$

$$-\partial U/\partial L[cx] + \partial U/\partial EV[\phi^{n+1} - \gamma^{n+1}] = 0. \quad (2)$$

Condition (2) says that the representative will expand the coverage of benefits ( $n$ ) to the point where the marginal disutility of lost leisure equals the marginal expected net vote gain as the marginal non-favored voter moves from being a "no" voter with probability  $\gamma$  to a "yes" voter with probability  $\phi$  of voting "yes".

The choice of  $n$  clearly depends on the functions  $\phi$  and  $\gamma$ . While we haven't made any assumptions about the shape of  $\phi$  and  $\gamma$ , we can still say some general claims. First, if  $(\phi(x) + \gamma(0))$  is close to zero, then the additional expected votes from extending the range of the public good are near zero as well. If, on the other hand,  $(\phi(x) + \gamma(0))$  is relatively large, for all  $k$ , then the size of the favored group will increase. Second, if the range of benefits is increased, the level of benefits  $x$  will be smaller than before the expansion. The reason is that the cost of producing  $X$  rises with  $n$ . Thus, the smaller the favored group, the higher the level of benefits for group members. In this sense, abstention matters. Those voters with low probabilities of voting tend to be kept out of the favored group. Third, those members of the favored group with higher than average probabilities of voting may be harmed by less

6 The zero benefits assumption is for convenience only. It plays no crucial role in the model. All we require is that the level of benefits to the non-favored group is less than that of the favored group.

7 If all voters were not identical, we might label them in descending order of their marginal contribution to the vote margin  $\phi-\gamma$ . In this case, voter  $n+1$  is the person with the highest value of  $\phi-\gamma$  among all  $N-n$  members of the non-favored group.

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abstention. If inframarginal members of  $n$  are not very responsive to changes in  $x$ , then the representative may be able to substantially increase  $n$  (and correspondingly substantially reduce  $x$ ). In this case, reduced probability of abstention may reduce the benefits of those with the highest voter participation rates. Finally, increasing the output of the non-favored group may significantly reduce the probability that non-favored voters vote, which again results in a transfer of benefits from the favored to the non-favored group.

So, we conclude that, indeed, the possibility of abstention affects the distribution and size of government benefits. The direction of the change in total benefits, however, is ambiguous.

## II. Remarks

1. In our setup, we have assumed that the representative possesses a great deal of information, in particular the probability functions  $\phi^i$  and  $\gamma^i$ . In reality, the representative likely only knows certain demographic distributions like income, race, education, occupation, and industry. The representative would need to know the probability of voting given  $x$  and  $X^A$  conditional on some observable characteristic, the frequency distribution of the characteristic over the population, and how the observable characteristic affects the valuation of government benefits. For example, income (a proxy for the value of time), or education (a proxy for cost of getting informed) are sometimes used to predict voter participation rates. With respect to the distribution of benefits, differences in the provision of public benefits output may be made along geographic (certain locations get more government output than others), industrial, occupational, or age lines. If voter turnout rates for these demographic categories are known, and the distribution of these characteristics in the population are known, the representative is better placed to discriminate among voter groups.

2. The ability of the politician to treat subgroups of voters differentially is limited by the existence of voters just on the margin between voting and not voting. If the distribution of voting costs, for example, is discrete, then non-voters will be treated less well than higher-probability-of-voting constituents. If non-voters were at the margin between voting and not voting, we would expect a more uniform distribution of benefits across constituents. In this case, it may make little difference in terms of benefits received that one ab-

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stains or votes. This is similar to contestable markets where the cost of entry of out-of-market firms affects the pricing of in-market firms.

3. In our model, the default level  $X^a$  is exogenous. A more general model would derive  $X^a$ .<sup>8</sup> For example,  $X^a$  might represent the rationally chosen output of the representative's opponent in the next election. In this case, the choices of  $X^a$  and  $X$  might be represented as the Nash-Cournot solution to a two-candidate election game.

4. Given the ambiguity of the analytical results, it may prove fruitful to assume some specific distributional forms (uniform, normal, Poisson, and so on) for the probability distributions  $\phi$  and  $\gamma$  as well as specific functional forms for the representatives utility and cost functions.<sup>9</sup>

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8 See LIZZERI AND PERSICO (1998) for a two-candidate model of public good provision with the possibility of abstention.

9 See MYERSON (1993) for an analysis of the discriminatory allocation of public benefits under different voting rules.

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## 20 The Transformation of Economic Systems

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- I. Economic Systems as Social Networks
- II. "Constructed" vs. "Organic" Evolution
  - 1. The Austrian View
  - 2. The Constitutional Economics View
  - 3. The Role of the State
- III. Two Stylized System Transformations
  - 1. Currency Conversion
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- IV. Elementary Economic Desiderata of System Transformation
  - 1. The Elementary Norms of the Target System B
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  - 3. Rational Incompleteness of the Norms of a System
- V. Sketch of Two Historical Examples
  - 1. West-German Currency and Economic Reform of June 20, 1948
  - 2. German Reunification of 1990
- VI. Big-Bang or Gradual Transformation?

**Abstract.** This paper deals with transformation issues along the lines of constitutional economics. Transformation is considered to be a mix of top-down and bottom-up developments. Given such a mix, what is preferable, a rapid transformation of a former socialist economy into a free market economy - or a more gradual one? This question is first discussed by use of the social network concept. Elementary desiderata of system transformations are developed. They are illustrated by the West German currency reform of 1948 and German reunification of 1990. The concept of human network capital is introduced and it is argued that the main impediments to rapid or big-bang transformation are the difficulties or impossibility of transforming human



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network capital. This is the time consuming part of any system transformation.

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The following note deals, in a conceptual manner, with the transformation of economic systems from a socialist economy to a capitalist economy, utilizing for the purpose some aspects of Constitutional Economics combined with social network analysis in the sense of multilateral relationships among social entities. There are basically two ways of transforming a socialist into a capitalist economy: purely *top-down* by replacing the old system - politically and economically - at one stroke by a new one, i.e., a new constitution, a new monetary order, rapidly freed prices, privatized production etc. (e.g. Sachs 1969) or - economically - purely *bottom-up* by leaving the old socialist political and economic system intact and offering or allowing the parallel development of capitalist institutions "from below" (e.g. Nee 1992, 1996). In this paper we deal with combinations of the top-down and bottom-up versions of transformation, i.e., cases which start with a top-down political reform, the replacement of the old socialist constitution by a new liberal one, and at least some top-down economic reforms as, e.g., a currency reform, some freed prices and privatized production, the building-up of a "capitalist" legal system etc. The kind of mix is of interest and the question of speed: what is preferable, a rapid, all-embracing transformation or a more gradual one?

We shall define "economic systems" as compound sets of social networks  $A$ ,  $B$ ,  $C$ ,... each consisting of actors (nodes), attributes of actors and relations between actors. The "transformation" of system  $A$  into system  $B$ , in its final stage, is defined as a mapping of network  $A$  into network  $B$ .

We shall proceed as follows: First, our use of the social network concept is explained. The concept of human network capital is then introduced. The purely top-down transformation of economic systems is, in the terminology of Hayek, a "constructed" procedure, while bottom-up transformations are spontaneous or "organic". Thus, some remarks on constructed versus organic orders follow. Next, two stylized examples of transformations are presented - a currency conversion and the transformation from a soviet type economy to a classical market economy. The properties of these examples serve as a basis for the discussion of the elementary desiderata of system transformations of the mixed top-down/bottom-up type. We next outline two historical examples

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(parallel to the two stylized examples above): the West German currency and economic reform of 1948 and the German reunification of 1990. Finally, we argue that the main impediments to a rapid or big-bang transformation rest in the transformation of human network capital. Marketable human network capital is in the end a matter of spontaneous or organic evolution. It cannot be commanded from above but has to develop from below. It is the time-consuming part of any system transformation.

### I. Economic Systems as Social Networks

Though the social network concept will be used here only as a metaphor to better understand our conceptual arguments, not as a theoretical instrument to model society, we must start with some definitions and theoretical interpretations. *Social networks* consist, as was mentioned above, of *actors*, *attributes* of actors and *relations* between actors (Wasserman and Faust 1994). Individual attributes include individual preferences, the type of choice behavior (economists assume rational choice), control of resources. The relations (or ties) between actors are channels for "*transactions*" ("interactions"), which are directed or controlled by a "*governance structure*" (Williamson 1985) or "*institution*" (J. Knight 1992, p. 2) - a set of explicit (formal) or implicit (informal) rules which structure social relations in particular ways. "Transactions" are to be understood *sensu largo*, not only as exchanges of material resources or information between actors (Furubotn and Richter, Ch. 2) but as any kind of "social action" (Weber 1968, pp. 22 ff.) "that establishes a linkage between a pair of actors." (Wasserman and Faust 1994, p. 18). In other words, the "transactions" of a social network include such "non-economic" relations as associations or affiliations between actors; movements between places; physical connections (a road, a telephone line); legal relationships (the formal debtor/creditor relation); biological relationships (kinship, descent); mental relationships (common views, beliefs, convictions, "culture"), and so on. Time plays an essential role insofar as the past and the expected future development of the social network influence the actors' present behavior. A social network at a particular point in time is to be seen as a cross-section of an imaginary tunnel reaching from long ago to a distant future. History and the expected future matter. The first is called by North (1990) *path dependency*. The importance of the influence of expectations of

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the future on the present is stressed by Keynes (1936, Ch. 5)<sup>1</sup>, by Lucas (1972) and in the present context by Arrow (2000). In analogy to path dependency we may speak of *expectation dependency*. In the language of network theory, the beliefs of *individuals* about their past and their future are part of the attributes of individual actors while their *common* beliefs about past and future are part of the "governance structure" or institutions of the relations between actors. Institutions control the handling of their historical views and their expectations and thus influence path and expectation dependency.<sup>2</sup>

An economic system consists of a *multitude* (or "aggregate") of social networks (Pappi 1993, p. 86). Thus each actor in an economic system has multiple attributes (debtor, boyfriend, employee, customer,...) and can have multiple relations with some other particular actor (as their creditor, girlfriend, employer, salesperson, ...). To simplify our language, we understand the terms "attribute", "relation" and "institution" as aggregates: an "attribute" of an actor is or can be a multitude of different attributes, a "relation" between two actors can be a multitude of different relations between them and, accordingly, a "governance structure" or "institution" can be a multitude of different institutional arrangements controlling the various relations between particular pairs of actors. Examples are the formal and informal networks within a firm or across markets. They constitute what we may call *human network capital*: the present value of the knowledge and skills of the network of employees, entrepreneurs and owners of firms together with the network of their suppliers and customers.<sup>3</sup>

Suppose we have a social network  $A$  consisting of a set of actors  $a$  with attributes  $\alpha$  and a set of interrelations between these actors  $ra$  governed by *formal* and *informal* institutions  $Ia$ . The letter  $a$  denotes the set of actors  $a$  with attributes  $\alpha$ . The letter  $b$  denotes the same set of actors but with attributes  $\beta$ .

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1 Expectation as determining employment.

2 We follow the "historical institutionalists" in the sense of HALL AND TAYLOR (1998, p. 18), a mixture of the "calculus" and the "cultural" institutionalist approach.

3 See, e.g., JOHANSEN AND MATTSSON (1985), BURT (1992, Ch. 1), POWELL (1990), POWELL AND SMITH-DOERR (1994). As the latter write: "Financial markets are increasingly learning how to evaluate the value of networks (of firms). In fields such as biotechnology, the industry business press,...., routinely comment on the quality of a firm's networks. A reputation for successful cooperation has become a valued asset." (POWELL AND SMITH-DOERR, 1994, p. 384)

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Note that the attribute of an actor's inner belief cannot be formalized (*die Gedanken sind frei* - "thoughts are free") while the institution governing the interrelation between believers can.

A transformation of *A* into *B* (in its final form) consists, then, of the transformation of each set of

- individual attributes  $\alpha$  into a set of attributes  $\beta$ ,
- interrelations between actors  $ra$  into a set of interrelations  $rb$  and
- institutions  $la$  into a set of institutions  $lb$ .

Some transformations can be achieved by sudden administrative or legal acts ("big-bang approach"), others only gradually ("gradualism"). The first emphasizes the transformation or establishment of formal institutions *from above*, the second a trial and error evolutionary approach *from below*. Thus, property rights can typically be transferred by a sudden, "*constructed*" legal act while, e.g., society's human network capital can only be changed gradually or "*organically*". To change society's human network capital is difficult because the human network capital already in existence in general cannot be transformed "one to one" into new human network capital. To a smaller or larger degree it has to be developed completely anew.

The "big-bang versus gradualism" question is thus related to the opposed concepts "constructed" versus "organic" evolution. They are central in Austrian economics. Before continuing, it might be useful to consider briefly these two terms.

## II. "Constructed" vs. "Organic" Evolution

Institutional change and institutional transformation are similar problems, ones of evolutionary economics, which has been for a considerable period of time a central concern of "Austrian economics".

### 1. The Austrian View

According to Carl Menger or Friedrich Hayek, some institutions arise (or are transformed) "pragmatically" (or by "construction") as

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"the result of the general will (agreement, positive legislation etc.) directed towards their establishment" (Menger 1883, p. 145),

others "unintendedly" (or "organically") as

"the unreflected outcome of human efforts directed to the achievement of essentially individual goals (the unintended result of these latter efforts)" (p. 145).

The latter developed themselves

"without any agreement, without legislative pressure, even, indeed, *without consideration of the 'public interest'*" (Menger 1883, p. 176; emphasis in the original).<sup>4</sup>

Among them are money, (p. 172), villages (p. 178), the state (p. 179), language, and the law (p. 180). These "spontaneously" established social phenomena, as Hayek later called them (1973, pp. 38 ff.), are described by Menger as "natural" or "organic" social phenomena (p. 146). For some reason, the "Austrians" have devoted much attention to the idea (or model) of "organic" or "spontaneous" evolution. However, on several occasions, Menger (1883) stressed that his "organic" understanding of an institution was adequate only to a part of social phenomena and that the pragmatic or "constructed" view of institutions is equally indispensable (1883, p. 148). Quite surprisingly, he ruled out mixed interpretations. For example, he regarded a pragmatic interpretation of institutions of organic origin (e.g. money) as inadmissible (p. 161). Furthermore, he saw the pragmatic origin of institutions as of no *theoretical* interest. All that was significant for him was the understanding of the (to him, possibly more miraculous in nature)

"origin of and the change in institutions that 'originated in an organic way', that is closely linked with the solution of the most important problems of the theoretical social sciences in general and theoretical economics in particular" (pp. 164 ff.).

The Austrians follow to some extent David Hume (1739/40), who at an early stage explained the concept of *convention* (in the sense of Lewis 1969).

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4 Menger is following DAVID HUME (1739/40), who early explained the concept of convention (in the sense of LEWIS 1969) with the famous example of two rowers in a boat, who pull their oars in time "tho' they have never given promises to each other" (HUME 1739/40, 542).

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But social conventions function only if there is either "a coincidence of interests"<sup>5</sup> among actors, i.e., if strategic or "opportunistic" behavior does not pay, or if self-enforcing implicit agreements work (as, e.g., in a customer relationship). Otherwise, explicit agreements or rules, enforced by an external authority (e.g., the courts), must be used.

The problem of the invisible hand mechanism of institutional evolution is that it works rather slowly and does not necessarily lead to desirable results.<sup>6</sup> It can be directed and speeded up by pragmatic actions such as, e.g., the passing of suitable laws. It is at this point that institutional or constitutional economics enters the scene.

### 2. The Constitutional Economics View

Representatives of Buchanan's constitutional economics, Eucken's *ordo*-economics, the property rights approach or Douglass North's new institutional approach to economic history use a mixture of both the concepts of constructed and of organic evolution - top-down and bottom-up development - to explain how institutions change or work. The hypothesis of the constitutional economic approach is that we have quite a good idea of how (on average) individuals will behave, given some institutional or constitutional "environment." Thus, by suitable institutional changes, we might be able to speed up the operation of the invisible hand and make sure that it aims in a desirable direction. Because of unforeseeable events, legislators and contractual parties know that it is wise to leave some room in the constructed design. This room will be gradually filled by the organic evolution of appropriate formal or informal rules. As a result, the constructed constitution will be enlarged or stabilized, i.e., become a stable mix of constructed and organic institutional evolution.

The basis of institutional transformation is a target set of *constitutional principles* (Eucken 1952, p. 254 ff.). The transformation from a soviet type economy to a market economy is dominated by the classical principles of *private property*, *freedom of contract* and *liability* for contractual and non-contractual obligations. To the now fashionable welfare state or "social market economy" a fourth principle is added, the principle of *social commitment*

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5 LEWIS (1969), the actors are indifferent with respect to the various possible coordination equilibria.

6 Because of the possibility of multiple convention equilibria.

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of individuals.<sup>7</sup> In addition, some basic functional principles are to be observed, in particular the principle of *sound money* (to guarantee the working of the price mechanism)<sup>8</sup> and the principle of *open markets* (to secure competition as a procedure of self-enforcement of promises and spontaneous improvement of institutions).<sup>9</sup>

Expressed in the "Austrian" terminology, the constitutional economic approach to system transformation is a blend of "constructed" and "organic" evolution. It starts out with some "constructed" (possibly "big-bang") transformation of the constitution and legal framework of society *A* into a new constructed order of society *B*. The remainder of the transformation of society *A* into society *B* is left to the "organic" evolution within the new institutional framework. The final product, the society *B* which is being aimed at, cannot be realized directly "by construction". The final result is a product of a gradual "organic" evolution. Whether the process ends in the state which we desire depends, i.a., on the possibly rapid introduction of a "constructed" new constitution.

### 3. The Role of the State

The role of the state is to provide the public good "basic system transformation" by "constructing", first, the basic framework of the new system; second, the general transformation procedures from the old to the new system; and third, the institutional environment which is able to credibly commit the state to the promised transformation (Furubotn and Richter 1997, Section 9.2). System transformation is unthinkable without sufficiently strong coercive power on the part of the state, yet such a coercive power is a double-edged sword. It can be used in both directions: to protect individual or common rights (as, e.g., property rights) or to take them away (e.g., expropriate individuals or communities). Individuals know this and will act accordingly. *Credible commitments* of the state (or policy makers) are therefore vital for

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7 A rather hazy principle. "It prohibits any misuse of freedom rights to safeguard individual positions of power at the expense of others"(STEIN, 1993, p. 175). The idea is that the "socially weak" are protected against the "misuse" of the otherwise constitutional rights of the "socially strong,." Equality before the law is, so to speak, weighted by the degree of social "weakness" of the individual.

8 EUCKEN (1952, p. 254) speaks of the "primacy of currency policy".

9 EUCKEN (1952)

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the success of system transformation. It is important in this context (particularly in an open society) to consider the role of interest groups. The commitments of the state have to be made credible by means of suitable institutional arrangements. Weingast (1995), e.g., emphasizes that federalism is an important political institution to credibly commit the state to the preservation of markets. By setting limits to the discretionary powers of the government, economic freedom can be enhanced. Attention is given in this line of discussion to what makes the restrictions of federalism self-enforcing. Weingast shows how these mechanisms work. In particular, credibility of property rights is an important condition for a successful economic transformation of soviet type economies into market economies. Riker and Weimar (1995, p. 94) hypothesize, e.g., that "the greater the credibility of a right to property, the greater will be the investment in improving the economic productivity of property."

Riker and Weimar (1995, p. 85) argue also that the disregard of the inter-relationship between economic development and the political processes by Western academic advisors is responsible for the malaise of development economics and the slow and hesitant economic transformation of post-communist countries. They point out that Western advisors have not been as alert to the political side of political economy as to the economic side. Consequently, they "initially proposed reforms for a well-operating market for free trade. But when these reform were undertaken, without solicitation of popular political support for the new economic system, the voters often became hostile to the reforms, which seemed to offer immediate suffering for only the prospect of future benefits." The authors continue: "Only in the Czech Republic ... did the government undertake economic reform balanced with a search for political support" (ibid.).

Expressed in the network jargon, the state "constructs", first, the new formal governance structure (order, constitution, institutional framework) aimed at, which is supposed to control the future relations between actors; second, the basic formal changes in the attributes of actors and relations between actors from the old to the new system; and third, the guarantee of the basic transformations. Path and expectation dependency matters, i.e., the actors' actual or believed past and expected future rights. The quality of the state's (or government's) guarantees depend not only on institutional arrangements but also on its history (or reputation). Note, however, that the state cannot do much more than to provide essential parts of the "constructed" (formal) part of system transformation. The "organic" (informal)



component of system transformation must work or grow "by itself". Human network capital, an important part of informal social systems, is typically "sunk". It cannot generally be transformed but has to be newly "grown" and this with in general enormous qualitative differences. In many respects, transformation policy demands a gardener's wit and patience.

### III. Two Stylized System Transformations

#### 1. Currency Conversion

Actors using the same currency as unit of account and means of payment form a *currency network*. Its governance structure depends on whether it is a commodity standard or paper standard. Both are well described in the literature. Whatever the currency standard under consideration, a currency conversion requires three "juristically ... necessary" features which Knapp (1905, p. 17) described as follows:

First, the legal system defines the new means of payment in a way that makes it immediately recognizable;

Second, the legal system lays down a name for the unit of account and confers this name upon the new means of payment;

Third, the unit of account which from now on will come into use is defined by establishing how it is related to the previous unit of account ("recurrent connection").

A currency conversion is in these ways a purely formal (top-down) affair, including its path dependency (the recurrent connection). What Knapp forgets, however, is that, in addition to path dependency, the expectation dependency of a currency conversion also matters. To become a sound money, the new money has to be fully accepted by the actors in the currency network. They will do so only if they *believe* in the purchasing power commitment of the supplier of the new money. If they do not, the currency conversion will destabilize itself, i.e. be destroyed by the invisible hand mechanism. The credibility of the purchasing power commitment of the money supplier can only to a degree be established by formal ("constructed") institutional arrangements (such as independence of the central bank from government direction). But it also must grow "organically". To that extent, Menger's counter-thesis prevails that money is not a creation of the legal system but "an unintended outcome of history." (Menger 1883, pp. 153 ff.)

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*Evaluation:* Expectation dependency aside, a currency conversion (in its pure form) brings little change to the social network of a currency community. Formal or "constructed" changes would do. They would concern neither the attributes of the individual actors nor the direction or character of their social relationships. Formal and informal relations between actors would remain unchanged: debtors and creditors remain what they were before the conversion, informal relations (human network capitals) remain untouched. Only some "numbers," expressing the units of money owed, their name and the appearance (or technique) of the means of payment would have changed. No distribution effects would be involved and thus no conflicts of interest would arise.

The situation is somewhat more complicated if expectation dependency is taken into account. Distribution effects may result from actors' doubts as to the purchasing power promise of the supplier of the new money. To a degree, the purchasing power commitment of the money supplier can be enhanced by a "constructed", self-enforcing institutional arrangement. As for the rest, trust has to grow by itself, i.e., "organically". But as we know from the two German monetary reforms of 1924 and 1948, informal confidence-building measures may grow and work fast, in a big-bang manner. One reason may be that only (rational) expectations matter, viz., as to the future purchasing power of the new money. No new human network capital has to develop. Distribution effects seem to have only a limited effect on the price level.

While the network effects of a (pure) currency reform are negligible, the same can hardly be said of a major system transformation such as the transformation of a soviet type economy into a market economy.

### **2. Transformation of a Soviet Type Economy into a Market Economy**

Such a transformation is quite radical. To a large degree, the attributes of individual actors, the direction and character of their social relations together with their governance structure have to be fundamentally changed. The economically relevant human network capital will be largely lost and must be newly developed - generally by different actors for different purposes under the leadership of innovative entrepreneurs. But not only the economy, the whole political body of the former soviet type economy including its political elite, ideology and power structure has to be transformed. Clearly, that is an extremely complex and demanding undertaking. It cannot be a purely top-

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down affair, commanded by a group of "transformers"; it requires also a considerable amount of bottom-up evolutions.

Applying Knapp's (1905, p. 17) three transformation requirements to the basic principles of a free market economy, the formal ("constructed") *transformation requirements* can be summarized as follows:

(1.) the legal system lays down the formal part of the new economic *constitution* inclusive of the new property, contract and tort laws,

(2.) the legal system determines the new individual *property rights, contract rights and liability rights*,

(3.) the legal system formally determines the "*recurrent connection*" in the sense of a clear-cut transfer of property and contract rights from the old (mostly collective) owners to the new (mostly individual) owners or creditors (including the recurrent connection of the unit of account and the payment of old debts).

The principle of the *social commitment* of individuals has to be taken care of, i.e., by the way in which property and contract rights are transferred (newly distributed), in particular as regards the transformation of pensions, social security, and tax payments, the latter being a new experience for citizens of former soviet type economies.

Path dependency and expectation dependency now play a role that is much more difficult to handle than in a currency conversion.

The term "*path-dependency*" belongs to the vocabulary of the New Institutional Economics à la Douglass North. By it, North understands the constraints imposed upon a decision by what has happened in the past.<sup>10</sup> Of interest are the initial social and legal positions (property rights) of actors plus their *common beliefs* (or ideology)<sup>11</sup> in general, and their common views of their history in particular.

Regarding path dependency, actors will lose much of their former attributes (in particular their former control of resources) and much of their social

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10 Much... of history is path dependent simply by nature of constraints from the past imposing limits on current choices and therefore making the current choice set intelligible" (NORTH 1990, p. 137).

11 On this, North remarks: "The study of ideology has been bedeviled by its origins in the writings of Marx ... and Mannheim ... on the relativity of knowledge to one's social position. ... But ideology can be studied as a positive science, and empirically testable propositions can be derived, as ROBERT MERTON (1949, p. 25) pointed out a generation ago in examining the literature on the sociology of knowledge" (NORTH 1978, p. 975).

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ties. They have to accept or develop new ones. Most will also lose their specific (sunk) human network capital and have to more or less completely re-orientate themselves. To be successful, they must completely revise their ideology or *weltanschauung*, i.e., their common ideas as to the way in which the world functions and how they believe it should be organized (North 1978, p. 975). They have also to change their views about their own history.<sup>12</sup> It is this change in their *weltanschauung* and moral values which unavoidably accompanies any "reform", "transformation" or "development". In fact, ideologies or social agreements are, as Arrow remarks,

"... typically harder to change than individual decisions. When you have committed not only yourself but many others to an enterprise, the difficulty of changing becomes considerable."  
(Arrow 1974, p. 28).

He goes on to say that what may be hardest of all to change are unconscious agreements, agreements whose very purpose is lost to our mind.

Examples are provided by contemporary developments in Eastern Europe.<sup>13</sup> For the reasons indicated, then, rational institutional change cannot help but be path-dependent. And the working of the invisible hand can be accelerated only within limits. Popper (1957, p. 64) is therefore against a *tabula rasa* policy and in favor of "piecemeal social engineering".

The role of *propaganda* and *education* is to be seen in this context. To save time, the planner of transformation must invest in both. As in the case of markets, openness to international competition matters (international competition in the arts, sciences, literature etc.). The transformation planner has also to create an environment conducive to the re-orientation or new formation of formal and informal social networks and thus, i.a., the change or new development of, i.a., specific human network capital. The significance of the education and up-bringing of the users of institutions - their culture - becomes understandable. As Popper expresses it:

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12 The more "transformations" the more changes of one's own history. West Germans had to revise their official ("political correct") views about German history four times during this century, East Germans five times - and no end seems in sight.

13 In illustration of this, see the results of a public opinion poll conducted by the Institut für Demoskopie Allensbach in Summer 1995: according to it, the East German population expressed increasing doubt about the Federal German economic system (FAZ 16.08.95, p.5).

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"Institutions are like fortresses. They must be well designed and properly manned." (Popper 1957, p. 66)

The "victory of reason" is the liberal goal. To achieve it takes a long time and requires an irresponsible optimism of those in charge and believing in it.

*Expectation dependency* has to now to cover a broad area of confidence of which trust in the purchasing power of money is only a tiny part. As argued above (in section 2.3), the credibility of property rights is a particularly important condition of a successful economic transformation of soviet type economies into market economies. Also important is the role of trust (and of competition policy) for the entrepreneurial innovations in human network capital, whose success determines the competitive position of the transformed soviet type economy in the world market. The "organic" evolution of human network capital through innovative entrepreneurs requires, besides trust in the government's word, also specific investments of all network actors in real resources and time. As in Austrian capital theory, such a "roundabout" production process requires its share of time. One cannot expect a rapid change like that characteristic of a currency conversion.

Because of the time needed to transform a soviet type economy into a market economy, the political process will sooner or later intervene. Disappointed actors will try to get a better share by political means. Resources are increasingly invested into political actions by which actors try to change the rules of the game in their favor. Thus, actors divert resources and time to playing the political game, instead of the market game.<sup>14</sup> As a result, the transformation process becomes increasingly an international or national redistribution process with diminishing real growth.<sup>15</sup>

*Evaluation:* System transformations of the type considered in this section are high cost undertakings which demand a considerable amount of time. To achieve a stable new result, the handling of path and expectation dependencies is vital. A sufficiently strong and disciplined government is necessary. Still, a purely "constructed" transformation will not do. The government cannot "command" inventiveness, it can only help to create an atmosphere conducive to the evolution of inventive network human capital. This takes time. No big-bang transformation, no quick fix or *Wirtschaftswunder* is to be

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14 Rent seeking activities (BUCHANAN 1980).

15 One typical argument of politicians is: "Entrepreneurs should better think up something (*sich etwas einfallen lassen*) instead of complaining all the time about the government."

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expected. Yet the longer the transformation process, the more vulnerable it is to the political activities of interest groups. This is the weak spot of any democracy, old or young. It is also the weak spot of the world market. Soft and brutal types of blackmailing are imaginable - and actually practiced.

### IV. Elementary Economic Desiderata of System Transformation

Taking system transformation as a mix of "constructed" top-down and "organic" bottom-up developments, and given our knowledge of institutional economics, what are the elementary desiderata of system transformation which economists would like to have observed by policy makers?

Basically the "transformator" has to construct or design

- the *elementary rules* (norms, order) of the system or social network *B* aimed at (its constitution and elementary set of statutory laws) and
- the *elementary transition rules* from the old network *A* to the new, sought for, network *B*.

The design of rules has its limits. Because of unforeseeable events, there can be no all-embracing rules. All formal rules (laws) are *volens in-complete*. The gaps they leave will be filled by some invisible hand mechanism. Given a particular set of rules, rational choice theory gives the policy maker an idea of how actors will behave (or decide). This knowledge will be used by the rational policy makers ("transformator"). They will construct the rules of the targeted system *B* and of the transformation process from old *A* to new *B* in a manner which makes the best use of the workings of the invisible hand. In this sense the basic rules of the target system *B* and of the transformation from *A* to *B* should remain *rationality* incomplete (Furubotn and Richter 1997, Section 1.7).

This paper is not the place for a detailed treatment of the economic desiderata of system transformation. Only a brief and incomplete sketch can be given.

### 1. The Elementary Norms of the Target System *B*

a) *General principles*: We shall concentrate on the elements of the *economic constitution*, which for Eucken (1952/ 1990, Ch. 16) consist of seven "constituting principles" (*konstituierende Prinzipien*). Among them are the three classic principles of private property, freedom of contract and liability for contractual or noncontractual obligations. The remaining four principles are according to Eucken (1) the basic principle (*Grundprinzip*) of the establishment of a price system in the sense of perfect competition, (2) the primacy of currency policy (in terms of fixed rules, Eucken suggests a commodity standard), (3) open markets (as freedom of trade, antitrust policy), (4) constancy of economic policy (*Konstanz der Wirtschaftspolitik*). These are typical classical (or conservative) principles. Eucken (1952, p. 143) was against full employment policy which, due to its credit expansion and its non-market steering mechanisms, tends to thwart the working of the price mechanism. The somewhat nebulous principle of *social commitments* of individuals (welfare state) is not part of Eucken's constituting principles, though it is an important part of the German constitution. It is hard to believe that any target system of today's transformation movements will not lean towards some kind of "social commitment", in particular regarding external effects and redistributional issues. This touches the issue of freedom. Thus, majority voting is particularly problematic in the case of "social commitment" and would have to be qualified as suggested by Brennan and Buchanan (1985) or Bernholz (1979, p. 514 ff.).

As Bernholz (1979, p. 512) points out: "To ask, in a rich society, for extreme equality of income and wealth and for security against all risks has by necessity the consequence that individuals lose their independence and are more and more directed by bureaucratic agencies." And he continues: "All collective decision processes, even if they are democratic, are in danger of suppressing minorities. Taking account of incomplete information and the necessity of representative democracy in large communities ... even majorities may be sometime outvoted by minorities. We conclude that co-determination tend to inflict negative externalities on members of minorities or even majorities even if it follows democratic majority rule (Buchanan and Tullock 1962)."

As for the legal system - property law, contract law, tort law - it would be more advisable for transformation states to employ *statutory law* than common law. Turkey took over the Swiss civil code, for example.

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**b) *Special principles:*** We shall now briefly deal with a couple of special principles of economic constitutions. We structure our exposition according to the five macroeconomic markets: labor, goods, capital, money and foreign exchange markets.

*Labor market:* Freedom of association became a constitutional right (German constitution Art. 9 section III) as a response of the free society to the continuous conflict between labor and capital. The constitutional right of free association is based on the neoclassical theory of bilateral monopoly understood as a segment of a large economy with zero transaction costs. Information and the formation of coalitions are costless. In this case, bilateral monopolies would be as efficient as perfect competition. This is not true for a real world economy with transaction costs in which the state has transferred the right to apply certain kinds of force (strikes, lockouts) to particular coalitions of private individuals. External costs of strikes and lockouts (and their potential for black mailing) aside, there exists an incentive for the wage bargainers to collude at the expense of the rest of the economy. They may tacitly agree to increase real wages, and thus leave unchanged or even increase unemployment, at the cost of institutions such as the unemployment insurance or unemployment assistance. In any case, neither union leaders nor entrepreneurs have an incentive to reestablish full employment. Union leaders wish to increase (or maximize) their unions' income from membership fees. Unemployment ratios in the range of 10 to 20 percent do not matter much in this context, for 80 to 90 percent of the work force still remain as potential union members. Firms are content with the rule of "marginal cost equals real wage" as long as they hope to be able to sell what they have produced (Richter 1999a). Both sides will stress later that they faithfully observed their "wage increase equals labor productivity increase" restriction (which has nothing to do with full employment) and will criticize the central bank and the government for doing nothing (or not enough) to overcome unemployment. The outcome is a bizarre situation, which should not be replicated in transformation states. The constitutional solution is to limit the freedom of association accordingly, e.g., by making it subject to antitrust law (as in the US).

*Goods Market:* Constitutional guarantees of private ownership (including intellectual property rights) are decisive. This must be seen in connection with Eucken's constitutional principle of open markets: freedom of national and international trade, antitrust policy. Early on, after transformation, the infant-industry argument for tariffs may apply (Haberler 1933, p. 278 ff.). The difficulty is to give them up again. Limits to taxation are in place. The



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problem is to make such promises time consistent. The parliament was formerly the natural institution to do this (North and Weingast 1989). But that mechanism is apparently no longer reliable. Brennan and Buchanan (1980) therefore demand a special tax constitution.<sup>16</sup> More effective might be a self-enforcing mechanism: the taxpayers' threat to terminate relations by leaving ("exit") the country. Telser's (1980) theory of self-enforcing agreements is based upon this threat. Yet if the country is big (like Germany) such a threat would at most be credible in the mouths of non-resident foreigners or of firms with relatively small specific national investments. Thus, a method to make "exit" threats credible would be to create sufficiently small, largely independent tax areas. *Tax competition* could do the trick. American- or Swiss- style federalism might help.

*Capital market:* A basic mistake is that transformation (or developing) countries - as well as supposedly helpful politicians from the more developed countries - stress foreign investments, not their own national capital accumulation. Yet the precondition of any development, individual or state, is that oneself not only promises to do so but actually does accumulate capital. This is the hostage which makes development promises credible. In addition, of course, the transformation state has to guarantee the free flow of capital. One might think of a special constitutional provision. But "paper is patient" (*Papier ist geduldig*). A probably more convincing method to make the promise of free capital flows credible is for a newly established transformation state to join an existing *international regime*, i.e., a network of cooperating states - described, e.g., by Alt, Calvert and Humes (1988). "Hegemonial cooperation" (Keohane 1984) is one such type of reputation-creating and -stabilizing international cooperation. To describe it, Keohane uses Williamson's (1985) concept of transaction cost economics. Note finally, that any promise of free capital flows is interrelated with the promise of particular kinds of foreign exchange policy. We shall deal with this below. It is related - together with the need for "sound money" - to Eucken's primacy of currency policy.

*Money market:* We know that what is necessary for the determination of the purchasing power of paper money is: The exogenous fixing of a magnitude expressed in monetary units (for example, the nominal quantity of

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16 They propose a certain tax structure like a proportional income tax or a progressive income tax formula becoming part of the constitution and could be changed only by a qualified majority. The same could be done with the value added tax and other indirect taxes.

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money M) and a rate of interest (for example, for a medium of circulation)<sup>17</sup> and the promise not to expand M at will as well as to keep that interest rate constant (as, e.g., zero on coins and bank notes);

Credibility of commitments, in this case of the money producer, is again of importance.<sup>18</sup> Again credibility cannot be "produced" directly but it can be achieved indirectly by "constructing" an appropriate monetary order or constitution. The monetary order is comparatively uncomplicated and thus lends itself to an explanation in some detail of the constitutional "construction" of credibility of government commitments. Basically the following rules have to be "constructed" to make credible the purchasing power commitment of the government or its agent, the paper money supplier:

The monetary system must enable the prospective money user

- to verify the fulfillment of the money supplier's commitment, and
- to enforce that fulfillment.<sup>19</sup>

So far as concerns the fulfillment of the purchasing power commitment, the dominant view of economists is that the central bank of a paper standard country must be independent of any direction by the government.

The theoretical argument for the independence of the central bank is that the bank's purchasing power commitment is enforced by the money users' implicit threat to destroy its president's reputation [Barro and Gordon 1983, 108]. There is an extensive literature on this view in the academic discussion on the theme "rules versus discretion".<sup>20</sup> To our mind this threat is not particularly convincing.<sup>21</sup> Much stronger is the implicit threat to terminate one's relations ("exit"). Yet, as we argued above, threats also have to be credible,

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17 PATINKIN (1961, p. 116).

18 The money users have to trust in the however of money understood value (SIMMEL 1930, p. 164).

19 Assuming individual rationality on the part of the person accepting the commitment, as economists generally assume.

20 The following may be mentioned: KYDLAND AND PRESCOTT (1977), BARRO AND GORDON (1983), BACKUS AND DRIFILL (1985), BLACKBURN AND CHRISTENSEN (1987), and PERSSON AND TABELLINI (1990) among others. For a survey see BLACKBURN AND CHRISTENSEN (1989) or the systematic presentation of PERSSON AND TABELLINI (1990).

21 No modern central bank is controlled by the president alone but by a board of governors or *Zentralbankrat* with its president being *princeps inter paris*. The utility function or "honor" of a group of ten or more people is a rather questionable pawn in the hands of the money users.

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and the implicit threat to stop using the national money in circulation is at most credible if expressed by foreign investors, not domestic. For domestic money users, the costs of switching to another domestic currency is equivalent to the threat to emigrate - which is a rather costly affair.<sup>22</sup> Things must really have gone downhill before people will pack their bags to leave.

But, again as argued above, there is the alternative of "voice" (Hirschmann 1970). - at least in a democracy. The elected government is subject to the credible threat of a "termination of relations" by those who elected it, viz. the domestic money users. The independence of the central bank from government direction, together with the central bank's legal obligation to safeguard the purchasing power of its money, may thus be seen as a credible commitment *by the elected government* to a policy of sound money.<sup>23</sup>

Because of the impossibility of foreseeing all future events, however, no precise commitment can be given. How then can the user of money verify whether the supplier of money has kept their word? We shall answer this question further below in the section on "rational incompleteness."

*Foreign exchange market:* Basically there exist three constitutional principles: absolutely fixed exchange rates, stepwise changing rates (*Stufenflexibilität* à la Bretton Woods), flexible exchange rates. The Bretton Woods System helped at least German economic redevelopment quite considerably. Yet it soon caused numerous problems, also for Germany, and eventually broke down, not without institutional economic reasons (Richter 1999b). Of interest for transformation countries remain absolutely fixed rates, achievable through *currency boards*, or *flexible exchange rates*. In the first case there is no exchange rate risk (provided the continuation of the currency board is credible). In the second case exchange rate risk is prevalent. - The currency board solution amounts to a union of a transformation state (e.g. Estonia) with some other currency community (e.g. Germany). The foreign currency is not *de jure* but *de facto* used. National currency in circulation is 100% covered by the foreign central bank money. The national interest rate is the same as in the host country. What is needed to start a currency board solution is a sufficiently high initial stock of foreign exchange and later, to avoid deflation, a sufficiently high current account surplus of the transformation

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22 Such costs are composed of the "sunk costs" of settlement in a currency area and the costs of the currency conversion.

23 Independence of the central bank is not a sufficient condition for the safeguarding of the currency; it may not even be a necessary one. Cf. on this CUKIERMAN (1992).

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country to increase its national currency in circulation at the rate of growth of its real GDP. The theoretical idea behind this foreign exchange order is the price-specie-flow mechanism of the gold standard. A lucky, though not perfect, example for its application is provided by Estonia (which was able to use its currency reserves secured from before World War II, cf. Karp and Siebke 1999). The question is whether and how this works, given, in particular, the enormous differences between the competitiveness of a transformation state and the country whose money it (de facto) uses. Flexible exchange rates are insofar less problematic but will result in high risk premia on national interest rates. There is, of course, the exchange rate risk involved particularly with regard to long term investments for which no forward markets exist. On the other hand, foreign investments are less important for economic development than an increase in exports and the accumulation of domestic capital.

*Evaluation:* As we have indicated there exist general and specific rules by which human behavior can be directed into a desired direction. But these rules have somehow to be enforced - either by third parties or "by themselves". The basic hypothesis of self-enforcement is "that someone is honest only if honesty, or appearance of honesty, pays more than dishonesty." (Telser 1980, p. 29). The enforcement instrument in this case is the threat to break off relations either directly through "exit" or indirectly, through "voice". Credibility plays a role - credibility both of the promise to provide what has been agreed upon and of the threat to break off relations through exit or voice. An important institutional economic issue is to analyze the role of credibility or reputation in political and economic life. As we have already noted, the "production of" or "investment in" credibility can be encouraged by the "construction" of a suitable institutional or constitutional environment.

In the language of *network analysis*, this section deals with the attributes of actors and the governance structures of their bi- or multilateral transactions. The initial endowments (by nature or law) determine, i.a., the attributes of actors. The constitution and legal framework offers the cornerstones of a network of paths to be used by the actors for their transactions. They leave room not only for transactions but, importantly, also for the "organic" evolution of *law*, contracts that is, by private actors, and it is assumed that actors take advantage of this opportunity. As a result of the private activity, the network of paths provided by the constructed legal order is filled out by a network of formal contracts between actors. Collectively, these contracts constitute a "voluntary legal order" built up spontaneously from below by

utility-maximizing individuals (v. Hippel 1963, p. 27). In effect, freedom of contract is the institutional counterpart to the principle of economic decentralization - which is presupposed by competitive market models.<sup>24</sup> In addition to the organic evolution of law "from below" we observe also the organic evolution of *custom* (Schlicht 1997), the non-legal institutional matrix of economic life. Clearly, the organic evolution of law and custom of the new social system *B* takes time, while a new constructed constitution or elementary legal order can practically be popped on the actors' head.

## **2. The Elementary Transition Rules from the Old Network *A* to the New, Target Network *B***

Given an ideal classical model with zero transaction costs, no transition rules would be needed - except one: the redistribution of absolute and relative property rights<sup>25</sup> of actors from *A* to *B*. The rest would work out immediately by itself. In this case, "big-bang" would be the right thing to do. Actors are immediately in the position to make long-term decisions. But the fact that in reality there are transaction costs will cause difficulties, e.g., in the re-ordering of property rights - of *privatization* in case of the transformation from a socialist to a market capitalist economy (or of socialization in the opposite case). Some economically important property rights, e.g., of human network capital, become completely worthless. There is nothing left of value for privatization. In other cases, e.g. land, privatization may lead to enormous transformation gains. Again, under the neoclassical conditions of zero transaction costs, the initial endowments of actors are irrelevant for the economic outcome. It will be Pareto-efficient whatever the initial conditions are. Motivation, effort, loyalty etc. are irrelevant for the outcome, there is no interrelationship between the economic and the political game. The latter is completely disregarded in neoclassical economics. Given real life conditions, privatization is no small task. The various ways and problems of privatization are widely dealt with in the literature. In the present context, it is sufficient to point out that it is a time- and resource-consuming procedure with economic and political side effects which must be taken into account and which require the development of "rational" (transaction cost-saving) transition rules.

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24 German legal literature speaks in this context of *Privatautonomie*, the principle that each individual is free to regulate the circumstances of his life by himself.

25 Ownership and claims.

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Thus, e.g., markets are not simply "there". They are public goods and, like all public goods, have to be provided or created by someone. Markets are special networks of explicit or implicit contracts between actors, the buyers and sellers. The organic evolution of law and custom is of vital importance. Individual feelings play a role (Frank 1990). Transaction costs in the form of asymmetric information disturb the beauty of the classical model of "demand and supply determining the price." Opportunism is prevalent as well as what we call the "political game", the legal or para-legal use of force (instead of exchange) as a means of resource allocation.

### 3. Rational Incompleteness of the Norms of a System

We stated above that the basic rules of the target system *B* and of the transformation from *A* to *B* should remain incomplete in a somehow rational sense. The reason are *unforeseen events*. There remains always room in constructed rules in which the invisible hand mechanism works. The point is that the economic planner (or "transformer") should rationally make use of unavoidable fact.

The NIE concept of "relational contracts" in the sense of Macneil (1974) plays a role in this context. According to this concept, actors and their representatives agree, either explicitly or tacitly, "about the procedure [the 'constitution'] that will be employed to deal with problems that may arise in the future." (Macneil 1974, p. 753). Moreover, it is accepted that negotiations on matters of concern will be carried on more or less continuously. Strategic or opportunistic behavior plays a role and has to be accounted for (Williamson 1985, p. 47). The problem is how to make incomplete agreements "binding" and thus credible; the credibility of commitments of the state (or any other promisor) is central for the success of the transformation process. As was argued above, self-enforcement matters. But there is the problem that, because of the impossibility of foreseeing all future events, no precise commitment can be given. How then can the actors (voters) verify whether their representatives (government, legislators) have kept their word?

Kreps (1990) attempts to provide an answer with his interpretation of the concept of *organizational culture*. Applied to transformation policy, the social planner has to spell out and commit credibly to a "principle" according to

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which he will react to unforeseen events.<sup>26</sup> That principle must fulfill two conditions:

The actors (voters) must

- be able to establish *ex post* whether the "principle" has been adhered to, and
- be convinced *ex ante* that the "principle" (the economic theory behind the principle, e.g., private property theory) will be successful.

In this way, despite the uncertainty of the future, the social planner can establish and defend its reputation for keeping its word (example of paper money see Richter 1999c).

In a sense, organizational culture is part of "expectation dependency" of transformation. The credibility of the promises by the "transformer" matters.

## V. Sketch of Two Historical Examples

To further illustrate our arguments, we shall present two historical sketches: (1) The West German currency and economic reform of 1948 and (2) The German reunification of 1990.

### 1. West-German Currency and Economic Reform of June 20, 1948

The technical part of the currency reform was more or less the same as the above described stylized currency conversion - with one big exception: the annulment of German governmental loans.<sup>27</sup> Considerable distribution effects were the result. An attempt was made later to at least partially compensate for them by the equalization of burden law. The additional economic reform was, compared with today's transformation countries, an easy task. The elementary legal structure of a market economy - property and contract law - still existed from the time before the war. It had been suspended and

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26 The "principle" should, according to the views of Kreps, possess the characteristics of a "focal point" in the sense of that term as used by SCHELLING (1960).

27 It was based on the Colm-Dodge-Goldsmith Plan of 1946 (see: COLM, G., DODGE, J.M., GOLDSMITH, R.W: "A Plan for the Liquidation of War Finance and the Financial Rehabilitation of Germany", *Zeitschrift für die gesamte Staatswissenschaft*, 111, pp. 204 - 243).

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overshadowed by war-time regulations, e.g. quantity rationing and price controls, which remained in force after the war. The economic reform needed to make the currency reform of 1948 a success, was thus comparatively easy - at least theoretically. All that had to be done was to abolish the war-time regulations. But to do just this was a considerable political problem which, in contrast to the currency reform, had to be solved by the Germans themselves. That was largely done under Ludwig Erhard's guidance, i.a., by the "Law of the Guiding Principles for Economic Control and Price Policy after the Currency Reform" which became effective four days after the currency reform.<sup>28</sup> It demanded the relaxation of rationing and price controls. By July 1948 about 90% of the statutory price regulations were repealed and the general price freeze of 1936 was suspended. The Guiding Principles also called for the restoration of competition, the application of credit policy measures and the relaxation of the wage structure.<sup>29</sup> As for the latter, the wage freeze was abolished on November 3, 1948<sup>30</sup> and the "Law Concerning Collective Wage Agreements" (*Tarifvertragsgesetz*) became effective on April 9, 1949.<sup>31</sup>

The constraints of "*path dependency*" helped more than hindered the economic reconstruction of Germany after 1948. Not only the elementary formal structure of a market economy but also most of the old property rights structure still existed from before the war (i.e., only some 10 to 15 years ago). Much of the informal ("organically"-developed) part of pre-war (or pre 1933) economic life was still alive: a social-liberal ideology with its distaste for Marxism as well as for "Manchester Liberalism" plus its corporatist tendencies; the technical knowledge represented by brand or firm names like Mercedes, Siemens, Bosch, Zeiss, Leitz and so on; the knowledge and skill of how to do business; the network of personal and business relationships within and across national borders; and so forth. In short, the human network capital of pre-war Germany still existed in spite of devastating human losses. As a

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28 *Gesetz- und Verordnungsblatt des Wirtschaftsrates des Vereinigten Wirtschaftsgebietes* (amerikanische und britische Besatzungszone in Deutschland) 1948, No. 12, Frankfurt am Main, July 7, 1948, pp. 59 - 62.

29 STOLPER UND ROSKAMP (1979, pp. 374 - 404).

30 Gesetz zur Aufhebung des Lohnstops vom 3. November 1948, *Gesetz- und Verordnungsblatt* 1948 No. 24, Frankfurt am Main, November 10, 1948, p. 117.

31 *Gesetz- und Verordnungsblatt* 1949 No. 11, Frankfurt am Main, April 22, 1949, pp. 55-56.



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result, the concept of "social market economy"<sup>32</sup> with its roots in the German Historic School, contributed to social peace. Of course, trade unions protested (Schmidt 1970, p. 141) and the social asymmetry emphasized by the unions was also felt by the population<sup>33</sup> - no wonder given the distribution effects of a currency reform which aimed not only at stable money but also the "Liquidation of the War Finance and the Financial Rehabilitation of Germany."<sup>34</sup>

As for the role of "*expectation dependency*" the Bretton Woods System with its fixed exchange rates and disciplining measures may have contributed considerably to the build-up of confidence. As for West Germany, there was only one devaluation in September 1949 (from 3.33 to 4.20 DM/\$ ). This new rate was certainly favorable to German exports. In addition, the import restrictions of that time protected the reconstruction of the West German industry. The Bretton Woods System also helped to discipline the financial policy of West German governments and strengthened the position of the German central bank. The Bank deutscher Länder, later the Bundesbank, still had to gain its reputation. "Expectation dependency" also played an important role among investors and consumers. But what determined the growing optimism of this time is difficult to tell.<sup>35</sup> That early optimism was soon reinforced by the success of the German economic policy. The average GDP growth rate of 1950 - 1960 amounted to 8.2%. Unemployment decreased from 11% (1950) via 5.6% (1955) to 1.3% (1960). Real wages increased by 60% between 1950 and 1960. Stable prices, an important issue for Germans, contributed to the

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32 MÜLLER-ARMACK (1966b) had introduced the term. The idea was, given a well-ordered market economy, that "...the growing wealth of the nation would enable society to take care of the weakest groups in a manner which no central planning system could afford. .... a true *social* market economy can, and indeed should, provide social security and protection to the weakest not only by private charity but also by a certain income- amount of redistribution via state measures. ... government should not intervene directly in the market process, but the re-distribution should be brought about by direct transfers." (WATRIN 1979, p. 420).

33 DOMES AND WOLFFSOHN (1979, p. 341) report: In July 1948, 79% of West Germans believed "that certain strata of the population gained special advantages through the currency reform." (quoted by Domes and Wolffsohn from NOELLE AND NEUMANN 1956, p. 151).

34 Title of the Colms, Dodge, Goldsmith Plan (WANDEL 1979, p. 322).

35 Right after the currency reform, in July 1948, 44% of West Germans polled looked more optimistically in the future, 24% more pessimistically (NOELLE AND NEUMANN 1956).

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build-up of confidence: the inflation rate averaged 1.15% between 1950 and 1960. International trade played a vital role in this process. The export quota (exports/GNP) increased from 8.6% in 1950 to 17% in 1960. Imports increased less and thus currency reserves grew considerably - from practically zero (1948) to 33.24 bill. DM (1960),<sup>36</sup> when 38% of West German currency reserves were in gold.<sup>37</sup>

*Conclusion:* The German currency and economic reform of 1948 was a transformation from a former market economy disfigured by war back to a peace-time free market economy. It was as "big-bang" as "big-bang" can be. The decisive "pragmatic" or formal actions, the currency reform itself and the central parts of economic reform, took place within a couple of days (or months if we include the *Tarifvertragsgesetz*). The resulting fast growth of German employment, of GDP, of foreign exchange reserves - with almost stable prices - was promoted by a favorable institutional environment: Path dependency and expectation dependency helped considerably. As for the first, the apparent high market value of human network capital must be mentioned. It contributed decisively to West German competitiveness in the world market. Regarding expectation dependency, the early, not overwhelming optimism was reinforced by the political process and the immediate and rapid economic growth itself. The importance of the political process for the success of a comparatively "simple" transformation such as the one under consideration is illustrated by the difficulties the British had with their return to a peace-time market economy after World War II.

### 2. German Reunification of 1990

The German reunification of 1990 is a special, not to say extreme, case of transformation of a soviet type economy into a market economy. Its basic formal parts were carried out in two steps which were only three months apart.

(1) The contract about the economic, currency and social union which came into effect July 1st 1990 after brief negotiations, lasting only about four months, between the representatives of the two states. The technical part of

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36 RICHTER (1999).

37 STOLPER, HÄUSER, BORCHARDT (1964, p. 254). The West German gold reserves were higher than in pre-1914 Germany during the times of the gold standard (loc. cit. p. 256).

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the currency conversion followed literally the above (in 3.1) described three "juristically necessary" features with an individual conversion rate ("recurrent connection") 1:1 for limited amounts of private money and 1:2 for the rest. Wages contracts were converted 1:1 (Streit 1999, p. 661).

(2) The actual reunification, i.e., the integration of the German Democratic Republic (GDR) into the Federal Republic of Germany October 3, 1990.

This was probably the most rapid formal transformation from socialism to capitalism in the world. The GDR took on, virtually overnight, the West German currency, the West German constitution, its legislation, administrative rules, economic order, social policy etc. Public administrations, courts, universities were turned upside down and newly staffed, to a large degree, with West German specialists.

Yet different from the 1948 currency reform, the constraints of "*path dependency*" were an enormous handicap for the East German economic reconstruction. The old formal structure of a market economy and most of the old property rights structure in existence until 1945 and later was thoroughly destroyed. Socialist ideology, detested as it may have been, had its effect on the way people explained the world in which they assumed they lived in. Much of the informal ("organically"-developed) part of the pre- 1989 economic and political life was still there: a (softened) Marxist philosophy, a strong distaste for competition ("elbow competition" was the slogan), strong corporatist tendencies (as in the West), a human network capital of no (or only little) value on the world market (compare the brand name of the Volkswagen in 1950 with the brand name of the Trabant in 1991 !), the knowledge and skill of how to do business in a centrally planned economy was there but it hindered more than helped the economic reconstruction of East Germany. It was more a network of amigo type connections, trained to sidestep the regulations of a centrally planned economy (mockingly called "rope teams" = *Seilschaften*). In addition there existed a not too small rest of the old political network. (The former Socialist Unity Party or SED continued to exist under a changed name: Party of Democratic Socialism or PDS).

Given such initial conditions, the rapid currency union had a devastating effect on the East German economy. The law of one price operated in an unhampered fashion. Not only the West German, the whole world market spilled immediately over into Eastern Germany. The until then highly protected, outdated East German industry was unable to compete on the world market which happened to be suddenly in front of their door. As a result, East German industrial production decreased in the second half of 1990 by 50%

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compared with the second half of 1989 (Bundesbank *Geschäftsbericht* 1990, p. 23). The law of one price contributed also to wage increases of 25% and 60% in the second half of 1990 - far above East German labor productivity.

While the conversion of monetary assets or liabilities was quite easy, privatization took time, particularly since a property restitution to their former owners (or their heirs ) was decided upon. This is a typical problem of path dependency which also influences expectation dependency: the credibility of the government's commitment to protect private property in the years to come and its effect on private investments now.

One typical argument against restitution was that it slowed down private investments and thus economic growth in East Germany. Compensation payments instead, would have separated the investors' property rights issue from finding former owners and from disputes over the level of their compensation payments (Sinn & Sinn 1992, p. 93). Property rights assignments would not have held up investments. The typical counterargument of our practical minded politicians was that compensation payments would be too expensive. Sinn&Sinn suggested linking compensations strictly to the act of sale. They do not mention that such a solution would not only open up the Pandora Box of political intrigues and machinations but would in effect be a legalization of the socialist state's expropriations – sweetened only by some difficult in evaluating and justifying compensations. Restitution was, I think, the more suitable way to make the state's constitutional guarantee of private ownership credible [a problem not mentioned by Sinn ].

*Expectation dependency* played a crucial role regarding the *propensity to invest* in East Germany. This propensity should not seriously have been expected to be high (though it was), because of

- the lack of high powered human network capital and the resulting lack of world market products (besides, e.g., Meissner Porcelain),
- the inability to compete on world markets (expressed by a low East German export quota)<sup>38</sup>,

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38 The East German export quota decreased between 1991 and 1994:

1991: East German export to foreign countries/GDP=8,5%; East German "export" to West Germany/GDP = 4,4 1994: East German export to foreign countries/GDP =3,5%; East German "export" to West Germany/GDP = 4,0%

The West German export quota had in 1950 about the same size as the East German export quota in 1991, but it increased to 17% in 1960, i.e., to much more than the East German total "export" quota (including exports to West Germany) in 1994. (The systematic record of commodity exports/GDP for East Germany was discontinued in

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- the low East German labor productivity,
- its completely outmoded and run-down infrastructure,
- the catastrophic environmental burdens inherited from its socialist past.

In spite of these known or foreseeable impediments to investment, German politicians expected (at least publicly) that investors would rush into East Germany immediately after reunification. The German Minister of Economics, Count Lambsdorf, expressed this hope in the unforgettable words: "The investors are waiting on their starting blocks!"<sup>39</sup> Only a (big-bang) transformation to a free market economy would be necessary, with the rest being done quickly and smoothly by market forces. A number of politicians and economists expected, unrealistically, a repeat of the 1948 West German *Wirtschaftswunder*.

Certainly, if we compare the East German situation after reunification with other former soviet type economies, the basis for expectation formation of foreign investors was superb. The high reputation of the German Bundesbank guaranteed sound money. The 40 years of the well-tried constitutional West German state guaranteed the security of private property and contract rights. Yet, as for the East German population, their expectations to become rich quick were unrealistically high. Kohl's colorfully expressed hopes of "flourishing landscapes" within five years were taken literally. Instead, no second *Wirtschaftswunder* occurred and disappointment among East (and West) Germans soon spread. It was reinforced by the almost continuous increase in East German unemployment, which averaged 15.5% between 1992 and 1997 and reached 18.2% in 1998.

*Conclusion:* German reunification of 1990 is an extreme form of a transformation from a soviet type economy into a free market economy. As in the case of the currency reform of 1948, its formal part was a "constructed" big-bang action. Its two decisive steps, the contract between West and East Ger-

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1995). The situation improved slowly in the following years. Still, compared with West Germany were exports relativ to the total turnover of the producing industry (*produzierendes Gewerbe*) in most branches relative low (see SR Annual Report 1998/99, Table 38, p. 94).

39 Lambsdorf forgot that West German net capital imports during the *Wirtschaftswunder* West Germany were limited to the first two years. From 1951 onward until 1964 West Germany had an active current account balance, a precondition for the Bundesbank's accumulation of foreign exchange reserves (see, e.g., *40 Jahre Deutsche Mark, Monetäre Statistiken 1948 - 1987*, Frankfurt am Main, 1988, p. 254).

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many about the Economic, Currency and Social Union of July 1st 1990 and the final legal integration of the German Democratic Republic (GDR) into the Federal Republic of Germany on October 3, 1990, were carried out only within three months. Yet the result was very different from what had happened after the 1948 German currency and economic reform. East Germany had, instead of a quick start, an immense economic breakdown of production for two years followed by six years of mixed growth, averaging less than 5%.<sup>40</sup> The unemployment rate increased to levels unknown in Germany after the Great Depression. Bonn coughed up transfer payments higher than the most pessimistic forecasts of 1990.<sup>41</sup> By 1998 they had amounted to more than one trillion DM. Transfers of such a size and duration are not necessarily an incentive to improve one's own lot, and they will be difficult to end. German reunification, in spite of many pleasant sides, does not look good.

Why such disappointing developments after 1990? The standard reply is that it was because of too high wages pushed up by West German unions eager to avoid "cheap labor competition". Certainly, East German wages were and still are far above labor productivity.<sup>42</sup> But even if they were not, the East German economy would have considerable employment problems. The reason is the enormous gap in world market- relevant *human network capital* between East and West Germany. The size of this gap is illustrated, as was mentioned, by the difference between such automobiles as the *Trabant* and the *Volkswagen Golf* or the *Wartburg* and any *Mercedes* model of 1990. No such gaps existed between West Germany and other Western industrial nations after World War II. They had all suffered during the war, a period of 6 years, but their losses of life and real capital were small or of a different kind than the heavy losses of East Germany's world market-relevant human network capital during its 40 years of socialism. Such a gap cannot be closed within a couple of years. Whole arrays of new products and production techniques were developed in Western Germany and the western industrial nations during that period of time. East Germans may have known of these developments but were not able to build equivalent human networks able to

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40 After the breakdown of the East German industry in 1990 - 91 economic growth in 1992 - 95 amounted to 7.6% on average, then decreased to 2% 1996-97 and 1.8% 1998 (RICHTER 1999).

41 Net transfer payments from West to East Germany amount to more than 100 billion DM per year since 1991.

42 East German labor productivity was 46% of West Germany's in 1997 while its wage level was 77% of West Germany's wages, see BARRO (1998).

compete with modern developments. Furthermore, given the increase in labor productivity, the East German demand for the new products could easily be supplied by Western firms. To regain its pre-World War II position, when it belonged to the top level of the Central European industrial area, East Germany has to develop new industries, i.e. to innovate, as all transformation states have to do. Innovation requires venture capital and that, for obvious reasons, has to be saved (accumulated) largely by the transformation states themselves. Foreign investors cannot do more than provide seed money. Finally, marketable innovations are in the first place the result of private enterprise. The state is a poor innovator as the breakdown of communism demonstrates. What the state (the government) can do best is to "construct" an institutional environment conducive to the "organic" growth of innovative, viz., internationally-marketable human network capital. The rest has to work out by itself and needs time and patience. Experience shows that poor regions adapt to rich ones only slowly - at a rate of no more than 2 - 3% p.a..<sup>43</sup>

## VI. Big-Bang or Gradual Transformation?

Our considerations and examples demonstrate the mixed role of big-bang actions in transformation policy. Important for the decision as to whether a rapid or a more gradual transformation from the previous socialist system *A* to a new market system *B* is appropriate, is to evaluate the three main impediments to change:

- path dependency,
- expectation dependency,
- the gap in human network capital between *A* and *B*.

The greater the gap between old and new (internationally-marketable) human network capital, the longer will probably be the process of adaptation. The point is illustrated by the difference between the economic development after the German unification of 1990 and the West German *Wirtschaftswunder* after the currency reform of 1948. The size of the gap in human network capital is, of course, a consequence of the history of system *A*. To that extent it is a path dependency problem, it is a particularly difficult one to solve. There are path dependency problems which are much easier and

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43 BARRO (1998).

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quicker to handle, as illustrated by the example of the "recurrent connection" in the case of a currency conversion. While there are considerable differences in the level of difficulties with path dependency, expectation dependency, i.e., trust in the announced new system, is more or less equally vital in all types of transformation, the rapid and the slow ones.

Since the size of the gap in human network capital is of vital importance for the period of adaptation, a closer look at the nature of "marketable human network capital" would be in place. The answer, though, has to be left to a later paper. Only this can be said at this point: marketable human network capital is a combination of human and social capital. It is more than the sum of individual human capital<sup>44</sup> of the actors of a network. It is also part of social capital as described by Schlicht (1984) or Coleman (1990), i.e. a set of obligations, expectations, and mutually developed norms and sanctions that evolve from prior social interaction.<sup>45</sup> Network externalities play an important role, i.e. positive external effects not only in production and trade but also (and importantly) in the creation of new technologies or products. Obviously, the transfer of money or technical knowledge, helpful as it may be for the start, is not sufficient to close the gap. It may even set the wrong incentives and slow down rather than speed up the transformation process.

A pure and rapid *top-down transformation*, as in the case of German reunification, may be politically necessary, though, one should not expect it to be rapidly successful economically. The speed of the transformation process is limited by the speed of the necessary bottom-up evolution within the new political and economic order. The other approach to system transformation, not dealt with in this paper, is (economically) purely *bottom-up*. It leaves the old socialist political and economic system intact and offers or allows the parallel development of capitalist institutions "from below" as in China (Nee 1996). A different approach of this type would be to offer a set of superior institutional arrangements as an alternative which can be freely chosen. The Romans are said to have this done with their money, language and legal system in the countries they had occupied. Note that both methods are implemented by a powerful state which forcefully insures that it continues to get its own economic share. The Chinese or Roman kind of transformation process will be economically - not politically - quite messy at the beginning and re-

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44 In the sense of SCHULTZ (1963), BECKER (1964) or MINCER (1958) - i.e. the market value of an educated engineer, a business person or a skilled worker and so on.

45 FURUBOTN AND RICHTER (1997), p. 272.



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quire some time to be completed. But it may be an open question whether its economic results, and possibly the desired political change towards more actual freedom, will really develop much more slowly or ultimately be less stable and trustworthy than in most of today's hasty transformation and development exercises.

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## **21 Will the Europeans Seize Their "Once-in-History Opportunity"? – Comments on James M. Buchanan's Essay "Europe's Constitutional Opportunity"**

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- I. The Unknown Goal of European Integration or Where is European Integration Heading To?
- II. European Decision Procedures: Unanimity or Majority Rule?
- III. The Economic Order of the European Community: Inconsistent Rules
- IV. Monetary Union: Will It Work?

In 1990, shortly after the the Iron Curtain fell, reversing the division of Europe, James Buchanan published an optimistic essay on Europe's constitutional future. In his estimation "Europe is now presented with a historically unique opportunity to achieve that greatness which has so long remained unrealized" (1990,1). His proposal involves a "federal union within which members of the separate units co-operate for the achievement of widely recognized and commonly shared objectives, those of internal (intra-European) peace and economic prosperity, within political arrangements that ensure individual liberties and, at the same time, allow for the maximal practicable achievement of standards of justice". The constitutional requirements for peace and prosperity according to Buchanan are constitutional guarantees of free trade inside and outside the union (p. 16), a monetary constitution based on competing national central banks plus equal rights for all European citizens to make transactions in whatever currency they prefer (p. 13) and, finally, a federal structure for the union, in which the member states share sovereignty, yet at the same time they should not fall into the centralization trap as the American states did in the post-Lincoln era (p. 6 and 17).

Regarding the question whether an European federal union could become effective, Buchanan expresses hopes that constitutional guarantees "will prevent the emergence of a monolithic' Europe". But he also stresses some

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strong concerns: warnings for policy-makers. "Excessive Europe-wide regulations, controls, fiscal harmonization, fiat-issue monopoly... would ...destroy much of the gain that economic integration might promise (p. 18)." A federal union of Europe could develop into a "positive-sum movement for all parties" (p. 19), or lead to the in secession of one or more of its member states (ibid).

Certainly, it might be interesting to survey Western Europe at the close of the last decade of the twentieth century along the lines of Buchanans views and proposals. Was he too optimistic? Or was the process of "Brusselization" - as he puts it - so strong that his prediction has been falsified?

Western Europe is currently not in a very healthy state. The British Weekly "The Economist" recently called Germany "The Sick Man of the Euro". Unemployment rates are unacceptably high in the key nations of Western Europe. European politicians utilized the summit in Cologne (Germany) in June 1999 to pass resolutions attempting to make the European Central Bank (ECB) an instrument of Keynesian employment policy. The elections for the European Parliament, held in the early summer 1999, can be seen as a sign of dwindling enthusiasm of the voters in "Europe". In most countries the voter's turnout was unexpectedly low.

In my following remarks I will point out from a Buchanian perspective where I see the constitutional problems of European integration. I confess that I am much more skeptical about the future prospects of the ongoing integration process. Four topics shall be discussed: (1) the dissent among federalists and non-federalists over the ultimate aim of European integration, (2) the repercussions of the introduction of majority voting, (3) the inconsistencies in the economic framework and (4) the tensions which the single European money might create.

### **I. The Unknown Goal of European Integration or Where Is European Integration Heading To?**

The unsettled question in the great debates on European Integration is the ultimate goal of the whole integration process. Winston Churchill in his famous speech in Zurich (1946) called for the provision of a structure under which continental Europe could live in peace, in safety and freedom. He used the often quoted phrase: "*We must build a kind of United States of Europe*" (Lipgens and Loth, 1988, p. 662) and pleaded for minimizing the barriers

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between European nations, for unrestricted travel and for common armed forces to prevent the preparation of future wars (Robertson, 1966, p. 4). He also pledged that defeated Germany on the one hand and liberated France on the other should take the lead (Issing, 1996, p. 12) to a brighter future in Europe.

During the first decade after the second world war (1946-54) numerous political initiatives were launched. Some aimed at building a "larger Europe" (for instance, the OEC and the West European Union WEU), others were in favor of the establishment of a "Little Europe" among France, Italy, the Benelux-countries and West-Germany. But neither a political union nor a common defense union were agreed upon. The Benelux-states rejected the former and the French parliament voted down the latter proposal (1954).

Since then an endless discussion has been going on, as to whether the primary aim of European integration should be the establishment of an economic union with free trade and unrestricted migration of the factors of production plus a single currency or whether the ultimate goal should be the foundation of a common state, a supranational federation. These topics can be discussed under the heading of the "finality of European integration" (or where is European integration heading to). For the first aim, the foundation of an economic union, an international or intergovernmental contract (from which a member state could withdraw) would be sufficient, whereas for the second aim, the establishment of a supranational union, an irrevocable agreement would be necessary. According to the preamble of the Maastricht-Treaty the Community is striving toward an "ever closer union of the peoples of Europe". But the treaty itself abstains from any further comments, whether a confederation of states, a federal state or a political entity *sui generis* - in other words: a political structure somewhere in between - is meant.

In a speech given at the University of Oxford under the ambitious topic, "Europe's Future in the Twenty-first Century", the former German Minister of Foreign Affairs, Klaus Kinkel, said, "We do not want the United States of Europe according to the North-American model. We do not want a European superstate. The European Union will not and must not question the special character of each member state. Europe gains its powers out of the great diversities of its cultures, its languages and its traditions. This rich potential must be preserved and supported."

A loose interpretation of this quote could be that Europe - a continent, not a country - needs (for historic reasons) a new architecture, a "third way" between the nation-state and a centralized superstate. But what is the criterion



for assigning powers and authorities to the different levels of that body? The evaluation of practical matters would be different, when analyzed from the perspective of a political union, i.e. a federal state or union, as opposed to that of a confederation or an international contract with an entry and exit option. This is what Buchanan has in mind, if I understand him correctly. But without an explicit or implicit consensus of the citizens of Western Europe on the ultimate aim of the political endeavors, European integration policy is more like sailing on the high seas without a compass than following an agreed upon goal.

## **II. European Decision Procedures: Unanimity or Majority Rule?**

In every union of states, wherever it is heading, the decision procedures are of crucial importance. In a union of sovereign states (i.e. a confederation) with small and large member countries, cooperation is based on the principle of unanimity. Where consensus between the representatives of the member states can be achieved, there is no reason to believe that one of the participating countries will be made worse off due to the respective policy measure taken. Any deviation from unanimity causes risks for those outvoted, thereby leading to tensions and conflicts. This is one of the central messages of constitutional economics.

Of course, it cannot be denied that in a multi-state union like the EC the decision costs could be quite high and that they are bound to increase with the growing number of member states. This has led the federalists to ask for a so-called double majority, which allocates votes not only according to the Maastricht Treaty counts, but also the population in the respective member-states. This resembles, if I understand it correctly, the famous "concurrent majority" proposal of John C. Calhoun in American constitutional debates. The acceptance of such a rule or the rule of a qualified majority of 71 percent - established in the Single European Act (1987) - could lead to a situation in which there are winners and losers.

The many pitfalls arising here, attract attention to the well-known recommendation of constitutional economics to draw a dividing line between fundamental rules on the one hand and statute law on the other (Buchanan 1985), thereby confining unanimity only to the constitutional level. But such

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advice might be difficult to apply in a setting like the EC, where the center of political power still rests within the nation-state and day-to-day politics tend to be highly interventionist.

The problem to be solved in this context is the discovery of rules preventing a country from slipping onto the losing track. Sometimes the rather naive view is put forward that the solidarity among Europeans will forestall such an outcome. But this would imply that conflicts of interest between member states are insignificant - a view simply not corroborated by the facts of political life in Europe.<sup>1</sup> Therefore, strict rules are necessary barring negative outcomes for participating countries in the long run. And only unanimity or a credible exit option opens the chance of favorable outcomes for all.<sup>2</sup>

This brings to mind Ludwig von Mises suggestion to abstain from the majority principle in multi-nation states as long as the parties in the respective parliaments are made up of groups organized by nationalities as opposed to political profiles. In his review of the collapse of the Austrian-Hungarian Empire after the First World War, Mises insists that even under democratic rule national minorities will not profit from majority voting, as long as the political process is dominated by cleavages among the different peoples (Mises 1919). A future European Union with eventually a total of 28 member states<sup>3</sup> in a decade or two would - under the assumption that present European law remains unchanged - increase the number of official languages from 1 today to 23, the number of seats in the European Parliament (EP) from 626 to 967 and the number of Commissioners from 20 to 35.<sup>4</sup> The argest country among the potential newcomers (Turkey) would receive 87 parliamentary seats, smaller ones (Cyprus, Slovenia) would have to be content with only six mandates, less than one percent of the total. Yet not the numbers but the voting rules, which are based on national representation, are the problem.

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1 See, for instance CONNOLLY (1995, p. 378) and his thorough analysis of the battles inside the Exchange Rate Mechanism (ERM) on monetary policy in the first half of the nineties.

2 This could also explain why majority voting is seldom used by the Council.

3 The fifteen EU-members plus the Czech Republic, Hungary, Poland, Slovakia, Bulgaria, Romania, Slovenia, Estonia, Latvia, Lithuania, Turkey, Malta, Cyprus. All states on this list have applied for membership or, at least, they will do so in the near future.

4 See STREIT AND VOIGT (1995). - For comparison, the US-Congress consists solely of 535 representatives and senators.

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Comparing unanimity and majority rule, the conclusion can be drawn that the unanimity principle is to be preferable. National preferences - determined by whomever in the political process - differ. Therefore, outvoting can easily create conflicts of interest with sharp political reactions diminishing political loyalty to the Union, which badly needs a boost from its position of low popularity.

The federalists claim that the price of failure to introduce majority voting would be that, in the end, the process of economic and political integration might come to a frustrating halt. But they do not take into account, that a forced integration policy not backed by widespread agreement of the citizens of the European nations could bring about the opposite of what the EU aims at, in other words, the strengthening of nationalistic tendencies.

### **III. The Economic Order of the European Community: Inconsistent Rules**

One of the main outcomes of the long debate on economic systems in the twentieth century is that only consistent rules are able to further economic cooperation. All efforts to establish so-called mixed economies combining elements of a market order with central planning have seriously failed. This makes it necessary to review the rule system of the EC, which has changed considerably since its establishment in the form of the Treaty of Rome in 1957. The original charter could be classified as a document based on the principles of a market economy with some important, but not decisive, exceptions in those areas which were named "common policies". Agriculture, Transportation and Energy are the most important ones. They are the sectors where dirigiste policies abound causing serious political tensions among member states, and even with third countries.

The Rome Treaty (1957) focused on building a Common Market between the six founding members and tried to define the rules to be observed to make such a market work. This was a very ambitious aim in the Fifties, considering the fact that all participants had a history of protectionism and bilateralism in the decades before. Not only was the removal of all sorts of tariff barriers necessary, but the free movement of factors of production also had to be reintroduced. Rules of competition, combined with the question of which state subsidies would be compatible with a Common Market and which

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would not, had to be agreed upon. And the basic principle of European anti-trust law, the rule of undistorted competition, had to be introduced (Art. 2 f and 85). French ideas of coordinating economic decision-making with the help of centralized directives from the state, the so-called *économie concertée*, or planification, were not included in the Treaty of Rome. All in all, it could be said that the principles of the market dominated at the start of the European integration process.

The Maastricht Treaty (1992), however, has changed this in a very important respect. Not only the number of common policies has been significantly increased, but under the heading of "industrial policy" the principle of market coordination was supplemented by opening a wide field for dirigiste policies. Written in diplomatic language, instead of clear legal diction, that Treaty amends the older text by endowing the Community with the responsibility to ensure that industry as a whole, as well as single undertakings, should be able to enter into competition with their rivals on the global market. The reservation is made that any industrial policy has to take into account the system of open and competitive markets in the EC; however, a long list<sup>5</sup> of the duties of the Community follows giving nearly unrestricted access to all kinds of discretionary policies.

It is obvious that the Maastricht Treaty opens, herewith, a nearly unrestricted playing field for all sorts of interest group policies and rent-seeking with never-ending quarrels over protective measures and other privileges to be handed out by the Community. Buchanan has often pointed out, that the influence of interest groups is one of the main reasons for the waste of scarce resources. In his essay he believes that the traditional interest groups have only a good chance to influence politicians under the roof of a nation-state. In a multi-state union as the EC will be, the power of the interest groups might lessen. Whether this is so is an empirical question.

Even though all this is important, it is not the central point here. The central observation is the simple fact that the economic constitution of the EC is

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5 On this list the following responsibilities are included: assistance in the process of structural adjustment, aid for the future development of undertakings, especially small and medium enterprises, promotion of conditions for the cooperation among businesses and the exploitation of the potential for innovation, research and development.

based on contradictory principles: the rules of the market, on the one hand, and the dirigism of the superstate on the other.<sup>6</sup>

#### IV. Monetary Union: Will It Work?

There is no other topic which was so fiercely debated in the EC countries as the introduction of the Euro which took place on January 1st, 1999. The economic arguments for establishing a single currency are not very convincing. Martin Feldstein, for instance, predicted in a scathing attack on European monetary unification not only economic, but also political calamities. Others forecast a money as stable as the German mark - a currency which has lost two-thirds of its purchasing power during its fifty years of existence. And C. Fred Bergsten recently praised the economic integration of Europe as the "most sensational instance of nations voluntarily relinquishing their sovereignty in favor of international collaboration" (Bergsten 1999, p. 34).

According to the views held by those favoring a supranational state, a "United States of Europe", the Euro serves two purposes: the completion of the common market, and an irrevocable step to the establishment of a politi-

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6 The Common Agriculture Policy (CAP) is a deterring example demonstrating where dirigistic policies might lead. The Treaty of Rome ruled in Art. 38 to 47 that European policy should (1) increase agricultural productivity, (2) ensure a fair standard of living for the agricultural community, (3) stabilize markets, (4) provide certainty of supplies and (5) ensure supplies to consumers at reasonable prices. Further, Art. 110 has to be taken into account. Here the Treaty indicates that the member states should aim to contribute to the harmonious development of world trade. It is easy to recognize that there is, as DENNIS SWAN writes (1992, p. 233), plenty of scope for conflict. The improvement of farm incomes requires significant price increases, but this conflicts with the interests of consumers. There is no indication given as to what is a fair income level or what is a reasonable level of prices. Certainty of supplies can be read as justifying a high degree of self-sufficiency reducing the access of third countries, especially those which are not associated with the EC, to the Community's food market which in turn jeopardizes the achievement of a "harmonious development of world trade". No wonder that the CAP is nowadays looked upon as a scandal, which not only consumes one half of the yearly expenditures of the Community plus unknown funds of member states, but also threatened in the eighties the cohesion of the community.

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cal union among the member-states. But are these two aims achievable by introducing a common money?

From an economic point of view several minimum conditions must be fulfilled to make a single money a success. Prices and wages must be flexible and factors of production mobile in the whole economic space, i.e. a real internal market must exist among the participating countries.

Officially, the single European market was completed in 1993. However, in fact impediments to trade (Art. 36 and 115) and also high barriers to labor migration still exist, since many member countries have introduced - with the approval of the European Court of Justice - minimum wage laws for workers having the effect of shielding the national labor markets against competition from other member states. No wonder labor migration is extremely low in the EC. As far as real shocks are concerned, there are many signs that the EC is not fully integrated and will not be so in the near future (Tichy 1993). Large depressed areas exist in the south of Italy and other countries of the southern periphery, in Ireland and in the North and in Germany, especially the Eastern parts. From this follows that up to now the traditional mechanism of counterbalancing capital and labor migration plus price and wage flexibility is not working well in the European single market.

Further, there is a strange institutional discrepancy in the political structure of the EC at large. Whereas in modern economies, monetary and economic policy-making are assigned to the level of the central state, in the Maastricht architecture only monetary policy is situated on the supranational level; all other economic policies remain under the control of the participating countries. Each member state can pursue its economic policies according to its national propensities. Monetary competition according to J. Buchanan's proposals was not on the agenda when monetary integration was discussed in the nineteenth century.

Such a constitutional design is destined to induce conflicts whenever the business cycles in the member countries differ. In 1999, the southern periphery (Spain, Portugal) and Ireland are booming, whereas the old industrial countries in the center (France and Germany) are suffering from high unemployment and low growth. The south needs a tight monetary policy to prevent inflationary developments and the center could gain from low interest rates thereby stimulating investment. But this is not the only relevant case. In addition, misled employment policies exist, which increase labor costs by mandatory cutting the weekly working hours as in France and possibly in Germany in the near future.

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Further, unsound national fiscal policies are followed in countries like Italy. In the latter case the treaty on monetary arrangements does not provide a bail-out obligation of the other member states; on the contrary, it strictly objects to any bail-out operations. From this it follows that a sovereign member country of the European Community could go bankrupt. But does that mean that the respective country would have to leave the union or would be excluded?

This and other considerations lead to the conclusion that by entering into a system of "irrevocably fixed exchange rates" a monetary union would sooner or later make it inevitable to take further steps in the direction of a political union by centralizing the fiscal policies of the member states. This, by the way, was the position taken by the so-called "monetarists" in the debates on the Werner Plan in the Seventies. For them a single money was the vehicle to bring about a political union of Europe.

Whether such a strategy of establishing a common state through the "backdoor" will work, should raise serious doubts. It embodies great risks and could lead to a collapse of the integration process in Europe.

To sum up, replacing the fifteen plus x European states in the long run by a federal centralized state called the "United States of Europe" - is, at least from the point of view of a liberal economist, not a very stimulating perspective, especially when sociologists are heard, who state that in the course of European history different national identities have evolved and that no signs are evident at present that a European identity is in the making.

Furthermore, historical experience shows that multi-nation states are extremely fragile. During the twentieth century not only the Austrian-Hungarian and the Ottoman empires have collapsed, but also the multinational and multilingual Soviet Union. The civil wars in Lebanon and Yugoslavia, as well as Czechoslovakia's break-ups and the Kosovo-war are the examples of the many problems arising in a multi-national context. This should not be misunderstood as a plea for a social order in Europe in which every ethnic nation should build its own state. The libertarian ideal is the civic nation (Dahrendorf 1990), in which people of different ethnic origin live together peacefully. The United States of America is probably the only historic case, where such a society exists successfully. The European case is more complicated, not least because of the many military conflicts which have taken place over the centuries. Perhaps it is more important for peace and harmony among European peoples that all of them establish true democ-

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racies, the rule of law and open market economies instead forming a super-state.

Starting from this perspective does not mean that the European idea should be dismissed. In the decades before the First World War, Europe - at least from Madrid to St. Petersburg - was a region where free trade and also a high degree of personal mobility existed (see the works of W. Roepke). The reconstruction of this world during the next decades would be a great success. But this makes it necessary to develop another approach to a European union than the one on which the Treaty of Maastricht has been built. Enlarging or widening the Community and not its deepening via a single monopoly money should have been the first priority of the European Community.

For the time being, the European Union is not very well prepared to overcome the problems it is now facing. Buchanan's ideas to create a loose federation in which the nation-states still exist but are losing power through the process of open competition and free trade are a constitutional alternative to what has been going on in Western Europe in recent years.

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## **22 The Role of a New International Monetary Institution after the EMU and after the Asian Crises: Some Preliminary Ideas Using Constitutional Economics <sup>1</sup>**

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- c) A Stable Legal and Administrative Framework
- d) Establishment of Control Mechanisms on the Fiscal Authority
- 2. Implementation Problems
- V. Summary and Conclusions

**Abstract.** A new situation has arisen after the creation of the European Monetary Union and after having experienced the Asian Crisis. In the light of this development a case is proposed for a more powerful and effective new international monetary organization. The policies of this new institution will be successful only if it is truly independent, especially from its major donors, so that it can act efficiently, if it is "called" to assist countries that have financial problems; and giving it the status to act like an independent central bank. This will permit this institution to control monetary policy, and to provide instruments to intervene in the country's fiscal policies, so that the goals of this new institution can be more effectively achieved. JEL-Class.: E42, F33, F36.

### **I. Introduction: The Consequences of the European Monetary Union (EMU)**

#### **1. Some General Remarks**

The creation of the Euro (or European Monetary Union (EMU)) promises to be one of the great economic events in modern history. It will certainly be the most important change in the international monetary system since President Nixon took off the US-\$ off the gold standard in the year 1971, which ended in the situation, that the world monetary system went into flexible exchange rates. The introduction of the Euro will challenge the status of the dollar in the international monetary system (compare part 2 of this paper): and will lead to a change of the monetary power configuration, because the monopoly situation of the dollar will be gone. For this and other reasons (like the Asian Crisis) the introduction of the Euro will be the most important development since the dollar replaced the pound sterling as the dominant international currency during World War I. The International Monetary Insti-

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tutions (like the IMF, the World Bank, etc.) will thus face new challenges and should react to this. In part 3 some theoretical ideas are put forward, how a new international monetary institution should operate. With the help of constitutional economics it will be shown, how such a monetary institution could look like, in order to operate much more efficiently and react more properly to major financial economic crises like the Asian one. In part 4 some elements of a "new" institutional design of an international monetary system are developed, in which a new structure will be derived, e.g., what the major tasks should be and how this "reformed" institution should operate. Part 5 gives a summary of the main results and draws some conclusions.

### **2. The Consequences of the Monetary Union for the EU**

The European Monetary Union has been an economic as well as a political project. This means, that the idea of the EMU has not been derived solely from an economic perspective and in particular, is not a straightforward implementation of the theory of optimum currency areas as the European Union cannot be regarded *ex-ante* as an optimum currency area.<sup>2</sup> Instead the EMU, which is at least partially justifiable in terms of modern economic theories<sup>3</sup>, has produced positive as well as negative expectations. These are shown in table 1:

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2 Compare e.g. ISHIJAMA (1995) and EICHENGREEN (1993).

3 Compare e.g. ALESINA AND GRILLI (1992), CUKIERMANN (1996), DEHAAN (1997) and EICHENGREEN, FRIEDEN AND VON HAGEN (1995).

Positive expectations	Economic theory
(1) Economic growth (in general) (2) (Faster) development/convergence of less developed EU-countries	New growth theory
Negative expectations	
(1) Higher inflation, especially in low inflation EU-countries (2) Increased (and permanent) onesided transfer payments	New stabilization theory Theory of optimum currency areas
<b>Table 1: Positive and negative expectations of the European Monetary Union (EMU)</b>	

**a) Positive Expectations of the European Monetary Union**

**(1) Economic Growth**

The scientific economic justification for the expectation of economic growth rests mainly on the following hypotheses: The introduction of the Monetary Union leads to a reduction of exchange rate uncertainty, hence, to a decrease in the risk premium of the interest rate and therefore to a decrease in the economy's real interest rates. Furthermore, it leads to a decrease in transaction costs, in particular in costs of the exchanging currencies and of insuring against risks of exchange rate fluctuations. In addition, it increases price transparency and thus leads to more competition and therefore also to price reductions with the consequence that the demand for consumption and investment increases. By using the results of the new or endogenous growth theory, it is possible to derive not only positive income-level effects as well as some important long-run growth effects. Thus, a reduction of real interest rates is supposed to lead not only to a substitution effect from labour to capital, thereby increasing per capita income (this is the typical effect, derived

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from the traditional neoclassical growth theory<sup>4</sup>), but also to "create" a learning effect, which leads to permanent increases in per capita income. This mechanism has been developed by the new growth theory<sup>5</sup>, which operates as follows: capital accumulation from the substitution effect leads to an increase in labour productivity, caused by learning effects and generated by additional knowledge embodied in the capital accumulation process. This process is extended by the public good aspect of knowledge, that is effective across firms, sectors and countries, and is embodied in inter-firm, inter-sectoral and international spillovers.

### **(2) Faster Growth of Less Developed EU-Countries**

The less developed EU-member countries have been supporting an EMU the most and want to participate in it as soon as possible. The reason is, that they believe it will foster their economic development.<sup>6</sup> One can differentiate between direct and indirect development-enhancing effects of the EMU. The direct development-enhancing effects are:

- the removal of exchange rate uncertainties;
- (the expected) rise in direct foreign investment; and
- a possible increase of financial transfers to the less developed European Union countries.

The most important aspect is the expected rise in direct foreign investment as a response to the elimination of exchange rate uncertainty. Here again, the expectations of substantial growth effects have been supported by the new growth theory. This approach argues, that the decisive development-enhancing factors are technology transfer from the higher developed countries and investment in infrastructure in particular in education and training (human capital) in the less developed EU-countries. The main hypothesis is: EMU would increase foreign direct investment in less developed member countries; and these direct foreign investments would bring in the technology needed for development. Based on this hypothesis one can derive positive spillovers to other sectors, which will lead to an increase in human capital in the whole economy. Indirect development-enhancing effects include all the positive stabilization effects that can be expected for less developed countries, but also for developed countries due to spillover effects from the pros-

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4 Compare already the classical contribution of SOLOW (1956).

5 Compare ROMER (1994), JONES AND MANUELLI (1997).

6 Compare e.g. ALESINA AND GRILLI (1992), ALESINA AND ROUBINI (1997) and CUKIERMAN, KALAITZIDAKIS, SUMMERS AND WEBB (1993).

pect of entering the European Monetary Union (EMU). The main stabilization effects are:

- the discipline forced by the convergence criteria,
- the credibility gained from the European Central Bank, and
- an increase in political stability.

These stabilization effects have a supporting function for the intended convergence, because the necessary sustainable growth process will occur probably in a situation of political and economic stability.

#### **b) Negative Expectations**

The negative expectations of the European Monetary Union, on the contrary, have referred mainly to the following two aspects:

1. Higher inflation in the low inflation EU-countries, and
2. Conflicts between EU-members because of large onesided transfer payments.

##### **(1) Higher Inflation**

Particularly in Germany, Austria, and the Netherlands, one of the main reason for the opposition of the EMU by the population has been the fear of an increasing inflation in these low inflation countries. There are different lines of theoretical argumentation for such a development. The main argumentation refers to structural differences between the member countries, which are: differences in the preferences about inflation and unemployment of the voting population, differences in market institutions, and differences in the fiscal systems.<sup>7</sup> The main hypothesis with respect to the derivation of inflation effects is: the price stability reputation of the newly established European Central Bank (ECB) will be lower than that of the former German Bundesbank, and consequently inflation expectations will tend to be higher for the previously low inflation countries, at least temporarily. Inflationary tendencies of EMU for the low inflation countries can be derived within this line of reasoning, when the following hypothesis is valid: Different "optimum" inflation rates of the single member countries will lead to compromises in the Monetary Union, so that the political pressure from countries with high "optimal" inflation rates will produce a kind of "average" inflation rate in the EMU, that is higher than the desired rate of countries with lower optimal inflation rates.

##### **(2) Transfer Payments**

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7 See e.g. WAGNER (1997).

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With the introduction of the euro, the exchange rate policy of the EU-member countries is eliminated and cannot be used as an shock absorption mechanism. Price (wage) flexibility and labour mobility are not sufficiently effective and developed in Western Europe, so that the great "fear" is, that the job of shock absorption has to be done mainly through financial transfers. As long as there is no constitutional EU-arrangement with respect to regional redistribution, such as the Austrian or German system of "Finanzausgleich", political conflicts will arise, because of the fear of in crises situation enforced discretionary redistribution associated with financial transfers.<sup>8</sup> Thus, an EMU which tends to produce political conflicts about the amount of fiscal redistribution, will destabilize itself. The worst possible consequence will then be a failure of or withdrawal from the Monetary Union, which would create large costs for the European Union and its member countries.

<b>Institutional arrangements:</b>	
<b>1. The Maastricht treaty</b>	
<b>1. Statute of the ECB</b>	(i) Commitment to price stability (ii) Independence of the ECB (iii) Prohibition of government deficit financing
<b>1.2. No bail-out clause</b>	
<b>1.3. Fiscal convergence criteria</b>	(i) Government budget deficit (ii) Government overall debt
<b>1.4. Monetary structural convergence criteria</b>	(i) Inflation convergence (ii) Long term interest rate convergence (iii) Exchange rate stabilization

<sup>8</sup> For first thoughts for an EU federal constitution compare SCHNEIDER (1996) and SCHNEIDER AND WAGNER (1999).



<b>2. At recent summits</b>	
<b>2.1. Stability pact</b>	(i) Fiscal and budgetary discipline
<b>Table 2: Institutional precautions/arrangements of the EMU</b>	

There are three areas of economic policy in which the Maastricht treaty introduced important institutional arrangements. These fields are:

1. monetary policy,
2. fiscal policy, and
3. structural adjustment policy.

**Ad 1: Monetary Policy**

Here, the statute of the European Central Bank is of particular relevance.<sup>9</sup> In order to minimize the inflation risk, the ECB has been assigned a strong position. This can be seen in the following three aspects:

- (i.) commitment of the ECB to price stability as its main goal (article 105 treaty establishing the European community (ECT)),
- (ii.) institutional independence of the ECB and independence of its employees (article 107 ECT), and
- (iii.) prohibition of government deficit financing by the ECB (article 104 ECT).

**Ad 2: Fiscal Policy**

In the fiscal policy area two aspects are important:

- (i.) the "no bail-out" clause (article 104 ECT), and
  - i. the fiscal convergence criteria, which restrict the government budget deficit and the overall government debt to certain (politically accepted) levels.

**Ad 3: Structural Adjustment Policy**

Further criteria set up in the Maastricht treaty are designed to ensure, that the structural convergence process has gone far enough. Countries that want to participate in EMU are obliged to fulfill the inflation, the interest rate and exchange rate criteria as laid out in the Maastricht treaty.

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<sup>9</sup> Compare WAGNER (1997).

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### **Ad 4: Recent Summit Agreements**

Here the provisions of the so called stability and growth pact agreed on in Dublin in 1996 and confirmed in Amsterdam in 1997 are particularly important. This pact provides a framework for maintaining and enforcing the Maastricht fiscal criteria after the EMU has begun. It restates the commitment to a maximum budget deficit of 3% of GDP and except for special circumstances applies sanctions to countries whose deficits exceed this level. However, whether such sanctions can really be enforced is an open question but at least an attempt has been made.

## **II. The New Tasks of the International Monetary Institutions after the EMU and after the Asian Crises**

### **1. The EMU and the US-\$ as the Two Main Currencies**

If one makes the assumption that the Euro will be a stable currency, a new situation arises in the financial world. Whether the Euro can compete with the US-\$ depends on whether it will be a stable currency; the stability of the Euro depends among others on the following four factors:

1. size of transaction domain,
2. stability of monetary policy,
3. stability of the political system and
4. fall-back value.

#### **Ad 1: Size of Transaction Domain**

It is obvious, that a currency, which is used by a hundred million people is much more liquid than a currency which is money for one million people. The larger the single currency area, the better it can act as a cushion against shocks. Comparing the size of the GDP of the European Union of eleven or fifteen member countries and with the ones of Japan and the USA all of a sudden, the EU becomes a monetary "player" on the same scale as the United States and Japan. Over time, as other EU-member countries join, as the per capita incomes of the poorer members of the EU catch up, and as the EU expands into the rest of Central Europe, the EU will have a substantially larger GDP than the United States. This size of the market is attractive not

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only for domestic, but also for foreign investors, mostly because of the stability and the size of the new currency.

### **Ad 2: Stability of the Monetary Policy**

As already argued in section 1.2.3, the European monetary policy will have the primary goal of price and monetary stability. Especially, if one analyses the institutional design of the European Monetary System all foreseeable steps have been undertaken for stable currency.

### **Ad 3: Stability of the Political System**

Monetary stability, of course, depends on monetary policy, and monetary policy is in turn affected by political stability. Strong international currencies have always been linked to strong and stable governments. How strong the European Political Union from a purely political perspective will be in the future, depends on whether the European Union is able to undergo major reforms in its political and economic policy organisations. There are some first (hopeful) signs, but this process has just started and it is an open question, how successful the European Union will be in this respect.

### **Ad 4: The Fall-Back Factor**

Most modern currencies have no real fall-back factor as the older currencies had, which were either gold or silver standards or convertible into one or both of those metals; hence unlike the modern paper currencies, the former currency had a fall-back value if the state collapsed. However, most European member countries have a considerable amount of reserves in US-\$ and in gold, which can be treated as a fall-back factor. If one considers these facts, the Euro should stand up against the US-\$, especially as it has two great strengths: First, a large and expanding transaction size, and a culture of stability surrounding the ECB in Frankfurt. Initially the EU-11 member countries will be smaller than the dollar area, but as other members enter, as the EU expands and as the poorer countries catch up, the Euro area will eventually be larger than the dollar area. From the standpoint of monetary policies, there is also not much to choose between the two areas. Information is globally mobile and there is no reason, why the ECB should not become as efficient as the Federal Reserve System in the United States. However, the Euro has still two weaknesses: it is not backed by an European Federal Union and it has no real fall-back value. In an unstable world these weaknesses could be fatal. A test will be when the Asian crises spreads out to the North and South American or to Europe.

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It is unrealistic to argue, that the introduction of the Euro leaves other things constant. If one assumes, that the Euro is successfully, it will then probably adopted by the remaining four members of the EU. Then counter-vailing steps might be taken by the United States including perhaps the expansion of the dollar area into Latin America. Whatever the forecasts the US-\$-Euro exchange rate are, it will become a matter of great concern to Europe, to the United States and to the rest of the world. Diversification from the dollar into the Euro would create the threat of a soaring Euro, which could come into conflict with the sensitive issue of unemployment in Europe. The alternative of a falling Euro would raise the expectation of an rising inflation that would necessitate deflationary policies. Hence, the most urgent focus of management will be on the dollar-Euro exchange rate. As a world moves from monetary unilateralism to monetary bilateralism, policy coordination will become much more important. Under unilateralism, other countries were comparatively free to fix or change their currency against the dollar, with a kind of benign neglect of exchange rate on the part of the United States. That will no longer be possible under the existence of the Euro. If intervention is required, it should be cooperative. In the view of the long period of transition from a mainly dollar world into a world, in which the dollar and the Euro are quasi equal partners, it maybe necessary to develop new institutions capable of dealing with this problem. What is the essence one has learnt from parts 1.2 and 2.1? For most western European countries it seemed worthwhile to shift domestic monetary policy to a transnational (European) level. The expectation and hope is that a better monetary policy will be the outcome, i.e. a stable hard currency and low inflation rates but also a better predictability of monetary policy. Hence such a change from a domestic institutional monetary arrangement to a transnational one may be worthwhile to consider also for development or industrial countries, if they face a financial crises and are not able to scope with it as we have seen in the Asian Crises. In the next two chapters a first and preliminary attempt is made to develop a new international financial institution with much more intervention rights as well as more flexible and more incentive orientated instruments than the IMF has it.

### **2. The Difficulties of Crises Prevention of International Monetary Institutions**

The financial and economic crises of Asia is one of the best examples of an unexpected event, which had neither been foreseen by private rating agen-

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cies, nor by the international monetary organisations. The Asian financial and economic crises resulted in an contraction of output, and employment and poverty are rising sharply. Negative spillover effects have affected numerous other countries and one cannot say get with confidence (March 1999) that a global crises has been avoided. At this stage, the growth in world output is projected at just 2,5% for 1998, about 2 % points below the projection made before the outbreak of the Asian crises – a loss of some US-\$ 800 billion in 1998 alone. The question arises, what can be done better in the future and what can be done by the international monetary institutions. The latter will be discussed – as an example – with respect to the reaction of the IMF; so far the only international monetary institution which has some experience in dealing with financial crises.

During the past two decades the IMF's surveillance has relied on indicators, especially in the periods between consultation-discussions, to monitor economic developments and to draw conclusions from their likely future trends. While a crises prevention is mentioned nowhere specifically as one of the IMF's main purposes, there is an urgent need to undertake reforms, so that the IMF can react more quickly and properly to events like the Asian crises. Thus, while the aims of the IMF are clearly more ambitious than mere crises prevention, the latter can be said to be an indispensable prerequisite for the achievement of these objectives. In so far, crises prevention should be indeed a core function of the IMF, and surveillance should be the IMF's principle tool for crises prevention. Hence it is no surprise then, that the surveillance activities, broadly defined, absorb the largest share of the IMF's human resources. Surveillance over the funds 182 member countries is, however, a continuous process, and the executive boards meets about once a month in informal country matters sessions, that aim to facilitate early identification of emerging financial tensions by focussion on potential problems and providing additional empirical material on a selective basis. The staff informs management monthly on important country developments, but also ad hoc when it is necessary. Beyond the usually annual consultation visits, formal financial arrangements, precautionary arrangements, informal staff-monitored programs and enhanced surveillance provide additional channels for more intensive contact between the staff and country authorities. The closer monitoring in the context of a quantitative framework, that accompanies these modalities of the IMF's involvement tends to reassure interested third parties, such as donors, creditors and financial markets, and thereby can contribute to crises prevention.

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It should be briefly mentioned that the IMF has also undertaken regional and multilateral surveillance. The former, which is increasingly becoming important in the surveillance of the European economies, complements bilateral surveillance in areas where policy responsibilities have been shifted to the supranational level. Executive board discussions of regional surveillance reports provide guidance to the staff in conducting bilateral surveillance with the countries affected. In the future, this is to be expected to increase with respect to monetary policy in the Euro area, for consultation missions to both EMU participants and countries, that have close links with the Euro era. The multilateral surveillance exercise provide valuable input for bilateral surveillance, e.g. in form of projections for the growth of trading partner markets or market assessments of country financing prospects.

The eruption of the Mexican crises in late 1994 and especially the outbreak of the Asian crises 2,5 years later raised severe questions about the effectiveness of the IMF surveillance. The issue of relevance to today's talk is not so much whether this crises could have been prevented. Of course, they could have been avoided through better economic policies or subsequently mitigated by the readiness on the part of the government in the crises countries to deal swiftly and decisively with the emerging panics.

If one examines the record of surveillance in the Asian region, the IMF appeared to have been more aware of the risks in Thailand's economic policy course than had most market observers. In other cases in Asia, however, the IMF, while having identified critical weaknesses, particular by the financial sector, had been taken by surprise, owing in part to lack of access to required information and also to an inability to see the full consequences of the combination of structural weaknesses in the economy and contagion effects. In particular, in the case of Korea, the IMF had not attached sufficient urgency to the financial tensions that had begun developing in early 1997.

From this short remarks about ability of the IMF to react to severe economic and financial crises it can be seen, that there is a need either to undertake major reforms of the IMF, so that the IMF is better able to fulfill its tasks; or to create a new international monetary institution. Both steps require, however, much more far-reaching rights than the ones of the IMF. It will be shown with the help of constitutional economics, that the new monetary institution will only be successful in handling this policies, if it can (re)act (at least for a certain time span) like an independent central bank with the additional rights to discipline governments and other actors in those countries. This new monetary institution can only act successfully if this institu-

tion is really independent; this means that no pressure from major countries can be put on it or that it might be misused as a lender of last resort. An attempt to develop and justify such a framework will be undertaken in the next two parts.

### **III. Some Theoretical Ideas About a New International Monetary Institution**

#### **1. The Economic and Political Independence of Monetary Institutions**

The modern theory of financial institutions (like central banks or international monetary institutions) stresses the importance of the independence of these institutions and of the incentive structures of the decision makers responsible for monetary policy. According to Grilli, Masciandaro and Tabelini (1991), the monetary institution can be described by their political and economic independence. Economic independence is defined as the ability of the monetary institution to determine the use and choice of its monetary (and if necessary other) policy instruments to act autonomously and without interference from national governments or national organizations.<sup>10</sup> Economic independence may be adversely affected by the monetary institutions obligations to finance national governments, to supervise commercial banks and by a lack of freedom to set interest rates.<sup>11</sup>

Political independence is defined as the ability of the monetary institution to choose monetary policy goals autonomously and without interference from the government. The basic determinants for this ability are found in personal independence, (e.g. procedures for appointing and dismissing the decisive managers of such an international monetary institution (and their terms of office)), in the national government's rights (or international institution's rights) to give instructions to the international monetary institution as well as

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10 This definition of economic independence is very similar to the meaning of instrument independence introduced for example by DEBELLE AND FISCHER (1994). These authors distinguish between instrument independence and global independence. Compare DEBELLE AND FISCHER (1994), p. 197.

11 Compare e.g. ALLESINA AND GRILLI (1992), p. 56.

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the right to veto, to suspend or to fire the top executives (of such international monetary institutions) decisions.

### 2. Institutional Solutions to the Time Inconstistency Problem

A starting point for the theoretical foundations of the independence of a monetary institution can be, that the behaviour of politicians is also greatly influenced by the existing rules of the political game.<sup>12</sup> Even for the simple case, that we have either benevolent policy makers (i.e. policy makers who behave like social planners) or we assume selfish policy makers who are opportunistic and have partisan preferences, the existing incentive constraints can lead to suboptimal policies. The fundamental reason for this is, that policy makers operate in a discretionary regime, i.e. monetary policy decisions are taken sequentially over time in a second-best world and therefore a socially desirable monetary policy may suffer from a lack of credibility caused by time inconsistency.<sup>13</sup> According to Blanchard and Fischer (1989), a policy is time inconsistent, when a future policy decision, that forms part of an optimal plan, formulated at an initial date *ex ante* is no longer optimal at the time the policy is implemented *ex post*, although there is no relevant new information.<sup>14</sup> Various economic decisions are based on agents' expectations of future monetary policy, if we assume, that a monetary authority is able to influence the inflation rate. For instance, when deciding on labour supply, wage contracts, investments or portfolio allocation, agents have to form expectations of the future inflation rate. In a discretionary regime, policy makers can make revisions of *ex ante* announced policy decisions and therefore create more inflation than forward looking agents expect. One possible way to deal with this "credibility" problem consists in removing all discretionary power from the government – however, quite an unrealistic assumption. The establishment of an independent (international monetary) authority would then be unnecessary, if a strict, legally embedded simple  $x\%$  money supply rule will be used. Government would then only have to pass a law requiring the government to fix the growth of money supply at a steady rate. However,

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12 In the Public Choice literature the selfish behaviour of politicians is extensively analysed and the importance of institutional arrangements is stressed. Compare MUELLER (1987) and SCHNEIDER (1994).

13 Compare PERSSON AND TABELLINI (1997), WAGNER (1997).

14 Compare SCHALING (1995), p. 25.



studies on the employment motive for monetary expansion show, that when stochastic shocks are taken into account, the optimal monetary policy does not conform to a simple rule but also includes an optimal shock absorption mechanism.<sup>15</sup> By following a simple rule the government might be able to eliminate the inflation bias, but would produce suboptimally high output fluctuations. On the other hand statutory entrenchment of the optimal state contingent rule appears to be extremely difficult, because it is hard to imagine how all contingencies might be described *ex ante* and verified *ex post*. What remains is a choice between simple rules, which are inflexible, and discretionary policies which lead to an inflation bias. It is this trade-off between credibility and flexibility, which has led to a game theoretic foundation of the independence of monetary institutions (like a central bank). In principle, two approaches can be differentiated: on the one hand, Rogoff's (1985), approach to delegate monetary policy to an independent "central" banker and the contracting approach by Walsh (1995 a,b) on the other hand. What both theories have in common, is that they propose the establishment of monetary institution structures which permit monetary policy to react to economic disturbances independently without interference from the government.

In the following some basic guidelines for a new monetary institution are developed using the contracting approaches, which seems more suitable for such a new framework.<sup>16</sup> However, they differ in their policy advice regarding the determination of central bankers' objectives and incentives. Starting from a principle agent approach Walsh (1995a) and Persson and Tabellini (1993) come to the conclusion, that even though the government should transfer the control of a monetary policy instrument to an independent mone-

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15 Compare ROGOFF (1985) and KING (1996).

16 Let me explicitly mention, that Rogoff's approach of a conservative central banker is also an attractive approach. Rogoff shows, that social welfare can be improved if the government delegates monetary policy to a conservative central banker who agrees with the social preferences regarding the target values of inflation and output, but places a greater weight to the inflation targets than the government. Once appointed, the conservative central banker operates under discretion and is independent to pursue an activist policy. By appropriate choice of the degree of conservatism a society realises the better equilibrium position than the government itself can achieve following inflexible rules or discretionary policy. For further elaborations see ROGOFF (1985), FISCHER (1994) and for an extension of this approach assuming a partisan interests of politicians, see ALLESINA and GATTI (1995). For a treatment in the context of the European Union, see WAGNER (1997).

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tary institution, the government should also provide this institution with incentives to optimize a social welfare function. This will be done in form of a (performance) contract between the government (as the principal) and the monetary institution (as the agent). Under the assumption, that the preferences of the government and the monetary institution coincide, Walsh (1995a) shows, that a simple contract which makes the central bankers' remuneration linearly dependent on a realised rate of inflation eliminates the inflation bias without any sacrifice in stabilisation efficiency. In addition he showed that the incentive structures of optimal performance contracts can also be generated through the implementation of inflation dependent dismissal rules (Walsh 1995b). Such dismissal rules come close to the corresponding rules of price targeting agreements practised, for example, in the New Zealand Central Bank System (Walsh 1995b).

As incentives in the traditional approaches depend exclusively on deviations between realized inflation from the socially desirable rate of inflation, performance contracts are frequently interpreted in the sense of direct inflation targeting as well. Svensson (1997) shows, that under conventional assumptions the result of an optimal monetary institution contract can also be achieved, when the government imposes an inflation target of the international monetary institution which is below the socially desirable inflation and other monetary targets.

However, an optimal monetary institution contract becomes considerably more complex if we consider "distorted" or selfish preferences of the governments. If optimal contracts are very complex, problems with regard to their implementation are raised, because it becomes more difficult to review the compliance and the design in the incentive structures. Walsh (1995a) shows as well, for example, that the incentive structures of an optimal monetary organisation contract are not solely dependent on inflation but also on output, if the managers of this international organisation try to maximize their income (Walsh 1995a, pp. 158 ff). Svensson (1997) highlights the importance of persistence in the labour market, which, among other things, leads to a discretionary monetary policy not only entailing an increased inflation bias but also a stabilization bias. The reason for this is, that surprise inflation also leads to real economic effects in subsequent periods.

In general these theoretical considerations show, that it is quite difficult to achieve from the monetary theory an optimal framework under which an international monetary organisation should operate. However, some of the

guidelines of the contract approach can be used for modelling an institutional design of an international monetary organisation.

#### **IV. Some Ideas About the Institutional Design of a New International Monetary Institution**

After having experienced the Asian crises, the existing international monetary institutions were not able to deal adequately with these problems. Either they gave the wrong advice or they were under considerable pressure from the major donor governments to behave in a way, which was in no way useful for the affected countries (like Indonesia or Korea). To lay down the right policies *ex ante*, so that such a major crisis can be overcome in the foreseeable time or even might be avoided in other countries is an awfully difficult task. Under the current structure of the IMF and especially the powerless instruments this organisation has to achieve its goals, one should think of a completely different (new) institution with much more enforceable instruments. The following suggestion may sound "wild" and normative but on the other side if one realises, what happens in such major financial and economic crises, like in Indonesia, Thailand or South Korea, it might be necessary to create a new monetary institution. If this institution is called for help, it should be laid down in an agreement between the affected country and this institution, that this organization may act like a completely independent central bank but coming from outside. For a certain period of time (one year, two years) one should give this monetary institution such a task, which all the influence of a central bank. The idea behind these suggestions is, that on the one side the moral hazard problem of the IMF (i.e. the IMF is a lender of last resort and bails out these countries) is considerably reduced and that this new monetary institution has a strong incentive to undertake policies for the affected country, which are suited best for it, because it has now the full responsibility with respect to the monetary policy over this country so that it can quickly act. As the financial help from the donor countries depends on the success to overcome the crises in this country, there are strong incentives for this new institution to act accordingly. On the other side there are now considerable higher costs for affected countries, because the governments in these countries lose a considerable part of their (monetary and fiscal policy) power, strong pressure can be put on them from the new financial institution

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to undertake necessary reforms, and (may be most important) the "easy" bail-out option does not exist any more! When creating such an institutional design for the new international monetary organisation two aspects are very important: The first is the institutional design and policy tasks of this new institution, and the second are the implementation problems.

### **1. The Institutional Design and Policy Tasks of a New Monetary Institution**

#### **a) A Two-Tier Banking System**

An important requirement of autonomous and successful central banking is the installment of a two-tier banking system.<sup>17</sup> This means, that there should be a strong and independent central bank and the new monetary institution should can play this role for a certain time, till it has reformed or built up such an institution together with a number of competitive commercial (private) banks. Once we have such a type of banking system, where the Central Bank sets out clear policy guidelines in controlling the private banking system (with minimum reserve and other monetary policy guidelines) a certain stabilization can be expected. But even when establishing such a two-tier banking system, the new international monetary organisation should be able to do more and to undertake a reform of the economic and financial environment of the affected state. In particular in the following fields major reforms are necessary: Thorough restructuring of the banking system, a stable legal and administrative framework and the establishment of control mechanisms on the fiscal authority.

#### **b) Thorough Restructuring of the Banking System**

A main precondition for an efficient conduct of monetary policy is a well functioning market-based banking system. It is not enough to commercialize state-owned banks and to give them new tasks and in addition let a number of new private banks emerge. In order to enable commercial banks to function effectively under market conditions, a deregulation and sometimes privatization of these institutions might be necessary and an adequate supervisory capacity is also absolutely necessary, because a weak and inefficient banking system hinders or even prevent a successful monetary policy: They distort the

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<sup>17</sup> Compare e.g. ROMER AND ROMER (1997), SAHAY AND VEGH (1995) and IMF (1997).

transmission mechanism of monetary policy, because unsound banks, that are not able to control the balance sheets, are less responsive to changes in reserve money or interest rates. In addition, the central bank (or the international monetary institution) may come under pressure to give credits for bailing out banks and to loosen monetary conditions thereby undermining their monetary control. Moreover, there are additional problems with unsound banks. There is a general consensus among economists that indirect instruments of monetary policy are more effective than direct instruments that promote more efficient financial intermediation.<sup>18</sup> In the presence of unsound banks, however, introducing indirect instruments such as a credit auction or similar market-based facilities may induce adverse selection and moral hazard effects, because unsound banks may be willing to borrow at any cost to avoid illiquidity. What is needed are institutional innovations such as specific supervisory policies and bank restructuring schemes.<sup>19</sup>

**c) A Stable Legal and Administrative Framework**

In order, for market economies to function, a stable legal and administrative framework is extremely important, as we have seen in the crises of some of the Asian states. The installment of a independent legal system, however, usually takes a lot of time. During this period, the investment process in the real sector as well as in the financial sector is hampered by great uncertainty. As long as a stable legal framework has not been established, private investments are regarded as very risky by potential investors. Thus private domestic investments tend to be very low and urgently needed foreign investments are delayed. However, it is not only the legal environment that counts, the administrative and moral environments are important, too.<sup>20</sup> Administrative inefficiency and corruption impose essential restrictions on the feasibility of projected monetary policy, rendering the assesment of the international monetary institutions performance very difficult.<sup>21</sup> During such a transition period this new financial institution can help to install confidence for domes-

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18 See e.g. ALEXANDER, BALINO AND ENOCH (1995) or DEMELO AND DENITZER (1997).

19 E.g. ENOCH AND BREEN (1997) demand this.

20 Compare WORLD BANK (1996, Chapter 5), FREYHOLD, GESSNER, VIAL AND WAGNER (1995).

21 Compare here the work by SCHNEIDER AND ENSTE (1998), who deal with corruption and the rise of a shadow or underground economy in developing states like the Asian ones.

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tic and foreign firms to invest in this "crises" country with a reliable monetary policy which brings back monetary stability.

### **d) Establishment of Control Mechanisms on the Fiscal Authority**

The domestic monetary institutions are more or less permanently under the pressure of the fiscal authorities to ease their restrictive (anti-inflationary) monetary policy. In the Public Choice literature, central banks are regarded as being exposed to strong political pressures to behave in accordance with government preferences.<sup>22</sup> The point is, that restrictive monetary policy aggravates the budgetary position of the government. Since a (temporary) slow down of economic activity, induced by restrictive monetary or disinflationary policy reduces tax income and receipts from seigniorage and since a short term increase in interest rates means an additional burden on public debts, that worsens the deficit, the government may prefer "easy money" and hence collect public support to push the Central Bank in this direction. Some evidence exists at the relatively independent U.S. Federal Reserve has often complied with such pressures and also the German Bundesbank.<sup>23</sup> Hence it seems to be very likely, that the relatively independent monetary institution will have difficulties to withstand such a pressure for a longer time. Such pressures from the fiscal policy side can make the commitment of the international monetary institution, to follow a steady anti-inflationary policy incredible since the sustainability of such a policy is doubted. This problem can only be overcome if some control mechanisms on the fiscal authority are established, like in the Maastricht treaty in the case of the European Monetary Union.

## **2. Implementation Problems**

In a perfect world all of the above mentioned institutional changes should be implemented instantly – and hence it would also be desirable to implement all reform elements simultaneously. This, however, is wishful thinking. The problem of sequencing and of making a wrong decision respecting the

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22 See for the U.S. AKHTAR AND HOWE (1991) and HAVRILESKY (1995); for Germany: FREY AND SCHNEIDER (1981) and BERGER AND SCHNEIDER (1998); for a survey see CUKIERMAN (1996).

23 See for instance ALLEN (1986) and ALLESINA (1989) but also BERGER AND SCHNEIDER (1999).

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sequence of reform steps cannot be neglected. For example it is not sufficient to have formerly independent monetary institutions in such crises countries, if they have not the sufficient institutional and political support for such a step. In order to strengthen the position of the monetary institution and to enhance the credibility of its announcements, there are two ways to improve the situation: The first way is to implement appropriate institutional control mechanism in order to control the inflation driving authorities or groups (such as the fiscal authority and wage price setting groups). Or one could bring forward the idea of the introduction of constitutional restriction of government debt. The second way is to choose an appropriate nominal anchor in order to conduct monetary policy successfully. The question of nominal anchors is important, because the credibility of the monetary policy strategy eventually determines the success of the monetary institution. Credibility, however, is dependent not only on the classical time inconsistency aspects (namely the incentives of the monetary institution to deviate from its goal) but also upon the expected implementability of the strategy that is a function of the reform stage.

### **V. Summary and Conclusions**

In this paper an attempt has been made to demonstrate that we have a completely new situation after creating the European Monetary Union and after heavy experienced the Asian crises. The European Monetary system has become a legal and institutional framework that a stable currency will be most likely the result. This changes the picture of the world financial system because two major currencies operate in this financial system which are competitors and where the rate between the Euro and the US-\$ is a crucial factor. In the light of this new development a first attempt is made to put forward some ideas of a more powerful and effective new international monetary organisation. It is argued that only the policies of this organization will be successful, if it is really independent especially from its major donors and can act independently if it is "called" for help in certain countries. Then it is shown, that various instruments should be developed for this new organization giving him a status of an independent central bank in an affected country for a certain time period, so that this organization can really control the monetary policy and has the appropriate instruments to interfere within the

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country fiscal policy aspects, so that the goals of this institution can really put through. In general this paper should be seen as a first attempt of suggesting new international monetary institutions under the aspect of two major world currencies, the US and the Euro and after having experienced the Asian financial and economic crises.

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## **23 On Conditions Favouring the Introduction and Maintenance of Stable Monetary Regimes and of Free Constitutions**

PETER BERNHOLZ

- I. Introduction
- II. Conditions for the Evolution of a Monetary Constitution
- III. Lessons to be Drawn for the Constitutions of Free Societies
- IV. Reasons for the Erosion of Free Constitutions and Efficient Market Economies by the Political-Economic Process
- V. Reasons for the Emergence and Revival of Free Societies

### **I. Introduction**

In 1996 I presented at a Monetary Conference of the Cato Institute in Washington a paper entitled *The Implementation and Maintenance of a Monetary Constitution* (Bernholz 1986a/1987). I had the good luck to have James Buchanan (Buchanan 1986/1987) as my discussant. Good luck because he turned his attention not to the monetary but to the constitutional problems involved. For I had asked and at least to a certain degree answered the following questions:

*1. Under which conditions can a monetary constitution emerge which is favourable to price stability.*

*2. Which conditions must be fulfilled so that such a monetary constitution has a good chance to be maintained for a long time.*

Buchanan realized at once that these were questions which could be asked for any constitution and derived a scheme to fit them into a more general framework. He stressed that Public Choice and Constitutional Theory had been mainly concerned with designing constitutions for free societies. But the political economy of how to establish such constitutions had been sadly neglected. He extended this analysis in two papers trying to provide some provisional answers. The first of them was presented at a meeting in Lugano, in

which we both participated, as *Prolegomena for a Strategy of Constitutional Reform* (Buchanan 1991a). In this article he turned his attention to the regulatory, the fiscal, and the monetary constitutions. The second paper *Achieving Economic Reform* (Buchanan 1991b) pointed first to the possibility of constitutional reforms after crises like wars, if the right ideas are available; and second, to Pareto-improving reforms, which may become possible as a consequence of an overextension of government. I will return to these arguments later. At the moment let me formulate the two problems, which were at the center of these discussions, and which have to be addressed by a more comprehensive theory:

1. *Under which conditions would it be probable for the constitution of a free society to arise and to be maintained.*
2. *How could knowledge gained concerning this first question be used to succeed with the introduction of good constitutions thought to be desirable for a free society.*

Unfortunately, it seems that we have not made much progress in answering these questions during the years which have passed since our discussions took place. I thus propose to return to these problems in the present essay, and to try to give some still somewhat provisional answers to the questions asked. In doing so I will first recall and extend some of the answers I had given in the paper mentioned above and in subsequent articles on monetary constitutions, and then turn to the more general case of constitutions for free societies.

## **II. Conditions for the Evolution of a Monetary Constitution**

Today widespread agreement exists among monetary economists, though hot debates about details are still raging, about the monetary regimes which provide for a relatively high degree of price stability (for the following, compare Bernholz 1990). The stablest regimes have been gold and silver standards, provided that governments could be prevented from debasing their currencies, i.e. from reducing the weight and (or) the gold or silver content of coins with an unchanged nominal value. That is, either a monetary constitution had to hinder the rulers from such interventions or they had to be interested themselves to keep currencies stable.

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Given, on the other hand, a discretionary paper money standard like that we "enjoy" today, it has been shown that a currency is the more stable the more independent the Central Bank of the respective country (Eijffinger and de Haan 1996). Other monetary constitutions linking the monetary system of a country by a credible fixation of its exchange rate to the stable currency of another country serve the same purpose. In doing so, especially Currency Boards denying discretion to monetary authorities have been successful (Hanke, Jonung and Schuler 1993). Such links have been established with gold standard currencies like the British £ before 1914, and later until today with relatively stable discretionary paper currency regimes dominated by independent Central Banks, like the US \$ and the DM.

The tendency of governments to misuse their monetary authority for fiscal purposes has been explained with the help of Public Choice analysis and been well-documented historically. The Belgian historian Henri Pirenne (1951), when looking at European Medieval times, explained that

*The progress of monetary circulation provided princes with the possibility to use it to their own advantage. Possessing the right to mint coins, they believed themselves to be authorized to use this in the interest to their treasury to the detriment of the public. The more money became indispensable for economic life, the more it was changed by those who had the right to strike it. ... At the end of the 12th century, the monetary disorder had reached a point that a reform imposed itself (pp. 258, 256).*

Indeed, in 1192, Doge Henry Dandolo of Venice emitted a new silver coin, the gros or matapan, which had the value of 12 old Carolingian deniers (pennies). This new money was soon used internationally and imitated in other European countries. A few decades later, in 1252, Florence issued the first gold coins, the florins (fiorino d'oro), following the example of Emperor Frederick II in Sicily. In 1284 Venice issued a replica, the ducat or zechin, and other countries and princes soon imitated this practice. The florin was widely used in Western Europe as a unit of account and in international transactions, presumably because of its stability in terms of other currencies, which was maintained for more than 300 years. But other currencies were not stable. For example, in 1300 5.8 Castilian maravedis had to be paid for one florin, but 66 in 1400 and 375 in 1500. Thus their exchange rate had fallen in the end to nearly 1/65 of that of 1300.

If the value of commodity money can be debased, the possibilities to misuse an overissue of money for fiscal purposes has been increased manifold with the introduction of inconvertible paper money. It is well-known that

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paper money has been first developed in China before 1000 A.D. This is not surprising, since the Chinese were the first to invent paper and also block printing. But given the political opportunities provided to rulers by monopolizing the issue of paper money, it is also not surprising that they were the first to invent paper money inflation. About all Chinese regimes which were not conquered before (like the Southern Sung by the Mongols) ended with a rejection and a substitution of their inconvertible paper money by copper or silver money, because of overissue of the former (Bernholz 1997a, Francke 1949, Lui 1983, Tullock 1952). Finally the Ming gave up paper money for good in the second part of the 16th century. Whether this was a planned decision to maintain the stable currency, which had returned in the form of silver bars and copper coins by currency substitution, I cannot judge.

The first hyperinflation in history occurred during the Great French Revolution. Here I define hyperinflation following Cagan (1956) as the time from the first month in which the price level rose by more than 50% to the month in which this rate had not been reached for a year. Since the first world war and the early 1930s, when the gold standard was abolished for good, the world has seen more than twenty hyperinflations (see Bernholz 1993a for a discussion of eleven of them), not to speak of many high inflations. One cannot escape the conclusion that this has been at least partly a consequence of abolishing the monetary constitution of the gold standard. Some years ago it has been thought that such events were mainly caused by wars (Capie 1986). But since the 1980s we have seen quite a number of hyperinflations not connected to wars, so that doubts concerning this hypothesis have arisen.

In view of the tendency of governments to establish a monopoly for the issue of money and to misuse it for fiscal purposes any introduction of stable monetary constitutions and their maintenance over a long period must be an improbable event. It is thus not surprising that it has scarcely been studied systematically until now (but see Bernholz 1983, 1986, 1990). Formulations like that by Pirenne that "*the monetary disorder had reached a point that a reform imposed itself*" provide no answer, but are rather a capitulation. Let me thus now describe the conditions which according to the just mentioned earlier work make the introduction of a monetary constitution probable:

1. *Hyperinflations*. During a high inflation currency substitution becomes more and more important. The inflating national money is driven out of circulation by stable money (copper, silver and gold currency, foreign exchange in the form of stable currencies like £, \$ or DM) (Bernholz 1989, 1996). In fact, a stable monetary regime evolves in time of high inflation even against

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strong punitive measures taken by the government. We can call this the natural way of reestablishing a stable currency (Subercaseaux 1912). I have documented five such historical cases (Bernholz 1989, 1997b). During hyperinflations this process of currency substitution accelerates and becomes visible to everybody. The government is in danger of losing its monetary authority, its base for the inflation tax dwindles and ordinary tax receipts are strongly reduced because of the lag between receiving and spending them (so-called *Tanzi effect*; *Tanzi* 1977), as already described by *Bresciani-Turroni* (1937/1931, pp. 72-74) for the German hyperinflation of the 1920s. As a consequence its tax authority would also vanish if it would persist to calculate and to receive its revenues in the rapidly inflating money. Moreover, the high and unpredictable variation of the rate of inflation typical for high inflations leads to increasing economic and social turmoil. It follows that the political chances of a successful reform introducing a stable monetary regime are the higher the higher the rate of inflation (Bernholz 1993a).

2. *The restoration of a stable monetary system, abandoned because of war, at the pre-war exchange rates, provided the domestic price level has not moved too far out of line with that of the most important trading partners during the war.* In this case the population wants to return to "normal" peacetime conditions after the war, where the pre-war conditions are considered to be normal (Bernholz 1987/1986, pp. 88-90). Since a deflationary process will be necessary to bring the price level again in line with trading partners which did not participate in the war or were less hit by it, the population would have to suffer for some time. It is prepared to shoulder some sacrifices for the return to normalcy, but not if they are too much of a burden. Politicians will respond to these wishes. Also if the country has been a center of international money and capital markets like Britain before World War I, there may be some advantages seen in restoring its importance by returning to the pre-war exchange rates (Kindleberger 1984, pp. 336-338).

3. *Imitation of the success of more stable currencies.* The population usually prefer a stable currency, and this preference becomes more important if they can observe stable currencies in neighbouring countries. Thus Latin American countries were often on a discretionary paper money standard during the 19th century, but they always tried to return to the gold or silver standards with full convertibility of notes, that is to the stable monetary regimes observed by them in the "civilized" world. As a consequence, their average rates of inflation were much lower than in the 20th century.



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4. *As a response to the removal of an undervaluation, an undervaluation caused by a moderate inflation, and which has diminished or turned into an overvaluation because of a more restrictive monetary policy initiated to fight inflation.* If a country with a regime of flexible exchange rates experiences an inflation higher than its trading partners, then an undervaluation of its currency tends to develop (Bernholz 1982, Bernholz, Gaertner and Heri 1985). After some time negative consequences of a moderate inflation are perceived by the population. Thus politicians can win votes by introducing a disinflationary policy, preferably soon after the elections. This leads, however, to a reduction of undervaluation or even to an overvaluation. It is thus resented by the export and import-competing industries and by the people employed by them. One way for the government to respond to these political pressures is to fix the exchange rate to a stable currency (or to reintroduce the gold standard) at a still somewhat undervalued level (Bernholz 1987/1986, pp. 90-96). This is inflationary in the short run but leads to a stable monetary regime in the long run.

Finally, the examples mentioned above for medieval times, suggest a fifth category of conditions for the introduction of a stable monetary constitution.

5. *A very open economy which can benefit from using a stable international currency as a medium of exchange and which can reap the seignorage if its currency is used widely internationally. A further precondition for this case to hold is that no other stable currencies widely used internationally are present.* It is obvious that a country can win more under these conditions by a stable currency than by debasing its money for fiscal purposes. For the stable currency attracts and furthers industry and trade and thus leads to higher revenues which are also increased by the seignorage. Note, however, that other countries may try to imitate this success, if their politicians see a chance to substitute their money for the international currency. Examples are the introduction of the florin and the ducat mentioned above.

In many cases, however, the international role of a currency was an unintended or even unwanted consequence of its stability. This is probably true for the Athenian drachme, the Byzantine hyperpyron (often called Bezant; a successor of the late Roman solidus), the Spanish piece of eight (reales; a silver coin, the ancestor of the US \$), the British £, the \$ and the DM. For the hyperpyron (Botha 1987) and the DM we have strong evidence that the monetary authorities even tried to prevent the internationalization of their currencies. The long stability of these currencies, that is the maintenance of a stable monetary regime, which could also be observed for the florin and the

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ducat, may, however, have been at least partly a consequence of the international use of these currencies. Another reason for currencies belonging to great empires *may* have been their importance for helping to preserve the unity of these empires. For it is interesting that the Romans kept the value of their gold coins (the aureus) rather stable during the third and fourth centuries when they strongly debased their silver coins. The same happened in Spain during the 17th century with the piece of eight, at a time when Castile debased its minor coins, the vellon currency (Hamilton 1933, Lozann Roldan 1990).

It is obvious that much work has still to be done to clarify under which conditions stable monetary constitutions emerged and which conditions were favourable for maintaining them over several decades or even centuries. For instance, I do not know why and under which conditions the Spanish piece of eight developed as a stable currency. On the other hand, it is quite clear that severe crises like revolutions and wars (already the Athenian drachme was debased during the Peloponnesian war, see Aristotle's *Frogs*) strongly increase the probability of abolishing a stable monetary system. This happened with the silver and gold standards during the French Revolution and the ensuing wars, during World War I and the Great Depression. That many hyperinflations followed wars, has already been mentioned. But the Spanish piece of eight was kept stable in spite of wars. Philipp II did not debase it in spite of three bankruptcies he had to declare. Thus such turbulence only increase the probability of the demise of a stable monetary constitution. On the other hand, a slow erosion of the value of currencies has been the normal state of affairs in history, presumably because of the domestic competition among politicians and the pressure of defence burdens especially for the finances of Great Powers. Finally, we should not forget that theoretical ideas and ideologies may lead to the erosion or abolishment of a stable monetary constitution or of money per se. Keynesianism and the efforts of the communists in the Soviet Union of the early 20s and the Khmer Rouge in Cambodia to get rid of money are examples. We have thus to conclude that a long-lastingly stable monetary constitution is a rare and impressive accomplishment.

### III. Lessons to be Drawn for the Constitutions of Free Societies

From the arguments presented in Section 2, the following conclusions can be drawn for the conditions increasing the emergence and maintenance of stable monetary constitutions. The probability rises with

1. *severe crises brought about by high inflations threatening the existing monetary and fiscal sovereignty;*
2. *the wish to return to normalcy when a period of upheavals like wars or revolutions has ended, provided that the environment has not changed too strongly;*
3. *if a policy of stabilization hurts important interest groups or parts of the population like export and import-competing industries and their employees;*
4. *an open economy;*
5. *imitation of surrounding successful monetary regimes.*

We have also seen that the probability of a breakdown of stable monetary regimes rises if

1. *great disturbances like wars or revolutions occur;*
2. *ideologies favour the abolition of a stable monetary regime or of money per se.*

Finally we have to add that there exists

3. *a permanent tendency to erode a stable monetary system because of domestic political competition and international arms races especially among Great Powers.*

Can these results help us in finding conditions which made and make it probable that constitutions of free societies are successfully introduced and maintained? To answer this question let us first turn to the importance of severe crises. It seems that crises were indeed important for the introduction of successful constitutions. The constitution of the United States was introduced after the War of Independence against Great Britain, accompanied by a high inflation, and after the Continental Congress had failed as a form of government. It is perhaps not surprising that the \$ was introduced at about the same time. Similarly, the first French constitution came into being as a consequence of the revolution of 1789, and the Swiss constitution was introduced in 1848 following a civil war. The Weimar constitution was introduced

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in Germany after World War I had been lost, and the (West) German Grundgesetz after the defeat of World War II.

But note, that also other types of constitutions than that of a free society may be introduced in the wake of such crises. After the crisis of the Meiji Restoration Japan introduced a constitution modelled on the Prussian constitution. Though this was probably providing more freedom than had been present before, it was, however, not a constitution of what we now consider a free society. Such a constitution was imposed on Japan by US occupation forces under general Mac Arthur only after World War II, but Japan stuck to it after the end of the occupation. More importantly, when the Shah of Iran had been driven out of office by a revolution of the population dissatisfied with too hasty reforms and the suppression by the secret police, a theocratic constitution was introduced (see: *The Islamic Constitution of the Islamic Republic of Iran*). This new regime implied at least for some years the suppression and annihilation of non-believers and opponents. It has been estimated that between 10000 and 20000 people have been killed in this process (Bigelow 1992; Cooper 1985). Similarly, a theocratic constitution was established in Geneva after the Protestant revolution had taken place and the Catholic Church been suppressed with the help of terror and force. Thus on 21 May 1536 the citizens assembled in public and swore by rising their hands, that they would live in the future solely according to the Bible and the word of God. Consistent with this oath, Calvin undertook a comprehensive theocratic restructuring of political and social life (Bernholz 1991). Indeed, the constitution turned out to be a totalitarian constitution (Bernholz 1995,1997c). From 1542 to 1546 alone, 58 persons were executed, some of them burnt at the stake; 76 were banned (Meyers Konversationslexikon 1903, pp. 708-709). It follows already from these examples that, though the time after crises may be favourable for the introduction of free constitutions, crises are certainly not a sufficient condition for such events.

Let us turn now to the second possible analogy, the return to normalcy after upheavals. I do not know, perhaps because of insufficient knowledge on my part, of any full examples in this category. Perhaps the introduction of the Grundgesetz after World War II in (West) Germany may be interpreted as a kind of return to the Weimar constitution after the demise of the Nazi regime and the war. However, a comparison of the two constitutions shows that some important changes were introduced, which were greatly influenced by the experiences gained with the weaknesses the Weimar constitution revealed under the attack of totalitarian movements (Nazis and Communists). Rather

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partial examples are the restorations of civil and economic liberties in Great Britain and the USA, which had been restricted during the first and second World War and the Vietnam War. Obvious cases were the abolishment of the compulsory military service of male persons of a certain age group, of the rationing of food and other commodities and of foreign exchange controls. If the environment, however, has changed strongly compared to the time before the upheavals, no return to former conditions would have to be expected. This was indeed the case for the draft, which was maintained for a longer time after World War II in several countries like the USA, Great Britain and especially France, presumably because the situation had changed because of the threat posed by communist countries. But it has to be mentioned that for instance Germany and Switzerland still stick to compulsory military service, though exceptions allowing a substitution by compulsory civil service have been granted and a discussion of the problem has set in recent years.

The third category refers to conditions in which the interests of important groups of the population are hurt by stabilization. Here I do not know of any direct application. But examples exist if the category is generalized to the case in which important groups of the population are in fact neglected or excluded by the constitution and (or) feel themselves to be so. Some groups may only after some time realize that this is the case, and that the promises of the constitution are not applied to them. Thus negroes in the USA got the franchise by a constitutional amendment in 1870, but it lasted decades until this and equal treatment were in fact reached. Also, in the course of time, women and the public at large perceived their exclusion from the right to vote more and more as a disadvantage. And it lasted decades until respective constitutional changes had been made even in the countries considered to have free constitutions. Another example is South Africa, where a majority of the population was excluded from the franchise because of their race, and it took a revolutionary movement to change this. Similar problems are still virulent in countries with a large number of foreign residents, as witnessed in 1998/99 by the heated debates among government and opposition parties in Germany about the introduction of a double citizenship.

Let us now consider the 5th category, which refers to the imitation of other countries. That imitation has played a great role concerning the introduction of free constitutions especially after crises is obvious. To appreciate this one has only to think of the imitation of the US constitution by many Latin American countries after their wars of independence against Spain, and of the constitutions of former British colonies after Britain had withdrawn

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from them in the wake of World War II and after several independence movements had arisen. But it is interesting to note that only a few of these constitutions were effective in guaranteeing free societies. Canada, Australia and New Zealand are the most outstanding success stories. The Swiss constitution of 1848 should also be mentioned again here, since it was modelled to a large degree on the example of the US constitution. Indian constitutional history after independence has also been successful on the whole. Whether the same can be said of South Africa remains to be seen after the franchise has been extended to non-whites. On the other hand, most Latin American constitutions as well as those of other former British colonies have not been sufficient to guarantee free societies.

A great deal of experimentation in imitating constitutions of liberty is now on its way in member countries of the former communist Eastern Bloc, of former Yugoslavia and of the former Soviet Union. Whether these experiments lead to success stories or not will be seen in the future. At the moment prospects seem to look rather good mainly for Poland, Hungary, the Czech Republic, Slovenia and the Baltic States.

The fourth category refers to the openness of a society or a country. Imitation itself requires already a certain openness, namely free access to relevant information and the willingness to learn from the example of others. But there may be also strong political and economic factors at work to create an openness of society. Rulers who wanted to acquire or inherit territories inhabited by populations with another religion than those of their old territories often had to become tolerant to reach their aims. Thus Elector Johann Sigismund of Brandenburg (1608-1619) turned from a Lutheran into a Calvinist in 1613, since he needed the support of the Netherlands to gain the succession to the Duchy of Juelich. As a consequence, he officially relinquished his *ius reformandi* in 1615, that is the right to determine the religion of his subjects (Guggisberg 1983), which had been established for the Holy Roman Empire by the Augsburg Treaty in 1555. The same policy was pursued by Frederick William, the Great Elector (1640-1688), to keep his states together and then followed by all of his Prussian successors. Several rulers also encouraged or tolerated the immigration of people with a different creed because they were highly productive (Bernholz 1995a, 1997c). This happened with the Huguenots in the Netherlands, the Swiss cantons and in Prussia. The Prussian kings allowed the immigration of protestants expelled from Salzburg. Earlier, the Danzig council encouraged the immigration of Dutch Mennonites, who settled in the Vistula delta near Danzig. And this "*was only the beginning of a*

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*remarkable colonization activity of Dutch Anabaptists in Poland, Prussia and Denmark, which lasted well into the seventeenth century"* (Guggisberg 1983, p.41). We will return to these reasons for establishing constitutions of liberty in the next section.

We turn now to the conditions favouring the abolishment or the erosion of constitutions of liberty and thus of free societies. As a first cause of the demise of a stable monetary regime we mentioned the onset of crises like wars, revolutions and economic depressions. It seems to be quite obvious that such events sometimes led to similar consequences for free societies. Without the Great Depression the Nazis would never have had a chance to grasp power in Germany (Frey and Weck 1981) and to dismantle the Weimar constitution. The Great Depression seems also to have marked the beginning of the end of Argentinian democracy. The meaning of the US constitution was strongly changed by the Civil War, since the importance of the states was greatly reduced. The terror during the Great French Revolution turned the constitution into a meaningless piece of paper and allowed the emergence of Napoleon's autocratic regime. But again, such crises are not a sufficient condition for the abolishment of a constitution of liberty. For such constitutions survived the Great Depression in the USA and Great Britain with its unwritten constitution, where only the party in power was either voted out of government or had to form a coalition. But it cannot be denied that the constitution of liberty was again weakened by these events in the USA.

We mentioned as a second category that the abolishment of stable monetary constitutions may be a consequence of ideological influences. This seems also to be true for constitutions of liberty. Thus it is highly doubtful whether the demise of the Weimar constitution could have happened without Nazi and Communist ideologies. And Fascist ideology played a great role in removing free constitutions in Italy and Spain. In all these cases a crisis happened and a struggle between liberal and ideological beliefs developed. And it depends on the relative attractiveness of these belief systems and on how well their adherents are organized which of them succeeds. Here it seems to be unfortunate that ideologies can often propose seemingly easy solutions to complex problems which are difficult to understand by the general population.

Let us turn to the last category. It should be quite obvious that arms races for military and foreign policy purposes may favour despotic or autocratic regimes. The more economic resources they require, the higher the financial burdens imposed on the population. But this is difficult for a democratic

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government to do, except perhaps in the case of a dangerous foreign threat obvious to all. Thus arms races encourage the evolution or maintenance of despotic and military regimes, at least when the economic capabilities of the country in question are not much superior to those of its competitors in the arms race.

It remains to discuss the competition of parties in democracies as a reason for the slow erosion of free constitutions. This subject will be taken up in the next section.

### **IV. Reasons for the Erosion of Free Constitutions and Efficient Market Economies by the Political-Economic Process**

In a democracy with a domain not adequately restricted by a free constitution, shifting majorities in parliament, i.e., small minorities of the population only inadequately controlled by rationally uninformed voters, can enforce their goals on the rest of the population. Since several parties compete for votes and need financial support to cover the expenses for their organizations and for election campaigns, one has to expect in time an ever-increasing sphere of government activities. Thus growing public expenditures, more and more regulations by government, tax loopholes and subsidies to special minority interests and pressure groups, flow from the incessant activity of legislative bodies. Such developments can happen because the majority of voters is rationally uninformed about issues. This is true for issues in which decisions impinge only marginally on the situation of consumers or taxpayers, since they then have little reason to incur the costs of informing themselves, given the negligible effect of individual votes on election outcomes. Thus protection of certain industries against foreign competition, the fixing of agricultural prices above market clearing levels, subsidies to coal or steel industries and the toleration or even promotion of cartels can be observed, though a majority of voters is hurt by higher taxes and/or prices. On the other hand, whenever changes like rent increases for housing are perceived by a majority of voters, since the expenditures for rents amount to a substantial part of their budgets, the government will take action in favor of the majority, e.g., by introducing rent controls (Downs 1957; Bernholz 1966). Also, a majority of voters may, with a proportional or progressive income tax, favour



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redistribution because the income of the median voter is usually smaller than income per capita (Meltzer and Scott 1983).

If the above arguments are correct, why is it that government activities are not increased at once under the pressure of political competition to a level at which each party maximizes votes? Why does it take decades for government activity to rise to ever higher levels? Several reasons have been given to explain this empirical fact. Olson (1965, 1982) points out that since it is difficult to form interest groups because they provide public goods to their members, it takes time to organize them (see also Bernholz 1969). The more diverse the interests and the greater the number of potential members, the more difficult the task and the longer the time needed to organize an interest group. As a consequence, cartels can only be formed and influence on the political system be exerted by interest groups after they have found enough time to be organized.

Bernholz (1966) has pointed out a second reason for the gradual extension of government, namely changes of the industrial structure brought about by economic development. These changes threaten old industries, their capital owners and managers as well as the jobs and the wage level of the people employed by them. This leads to voter dissatisfaction and thus, under the pressure of political competition, to government intervention to maintain or to win the support of those voters and of their families who suffer from the changes in the industrial structure. A third reason sometimes mentioned in the literature is more or less closely related to the second: "*The need to keep in check the forces which might produce unemployment is not the only root of the expansion of government control over industry and trade, because the sheer growth of complexity of economic structures requires more coordination, and the number of tasks which cannot be left to private initiative - such as prevention of soil erosion, traffic control, smoke abatement and so on - grows incessantly*" (Andreski 1965, p. 355). Finally, time is needed to invent new governmental measures, to introduce and to pass new legislation, taxes and subsidies.

The economic development of the West, of which capitalist economic growth during the last 150-250 since 1750/1850 has been the latest outcome, had far-reaching consequences for Western Civilization. It should first be mentioned that this development was a precondition for the evolution of democracy. For it seems now to be well-established that prosperous nations are more likely to be governed democratically than poor ones (Bollen and Jackman 1985, Lipset et al.1993, Burkhart and Lewis-Beck 1994, Weede

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1996a). And we have seen that prosperity is a consequence of free market economies with safe property rights.

But this is only part of the story. The consequences of restructuring and globalization extend to the very life of society. This follows already from the changing pattern of consumption and of the kinds of employment available to the greater part of the population. The working hours needed for producing the increasing wealth decline and available leisure time rises. Tourism and travels to foreign countries are among the most rapidly increasing service industries. All this changes by necessity the outlook and behaviour of people who now become acquainted with different life styles and foreign cultures.

The rise of government expenditures is at least partly a political consequence of the restructuring of the economy. For in the aging industries jobs are destroyed, whereas new ones are created in the newly developing sectors of the economy. Given a certain speed of this development, there will not only be pressure on profits and wages, but also unemployment in the old industries, since the people laid off are often not capable and willing to take up a job in the new sectors. Given these conditions, politicians can gain votes by helping the "endangered" industries with regulations restricting competition and with subsidies and by supporting the unemployed.

Increasing wealth allows also longer formal education, which is itself a precondition for further economic growth. Infant mortality and the number of children decline, and the average expected life span increases. This leads to a growing population until the smaller number of children overcompensates the other factors. An overaging of the population is then a further consequence of economic growth, which leads to additional social and political problems.

The restructuring of the economy with the declining importance of agriculture and the crafts brings about the demise of the great family. With increased real incomes and job opportunities it becomes possible for individuals to care for themselves and to follow their own inclinations independent of their families, that is to "realize themselves". This is especially true for women. As a consequence, even the small family of husband, wife and children is more and more questioned. The divorce rate rises. The number of children decreases, since the upbringing of children is labour-intensive and implies a substantial financial burden for parents. But human beings need care and help during several periods of life, namely as children, in case of severe illness and often during old age. But since the supporting structure of the large or even small family is now missing, innovative politicians are motivated to step in. Thus obligatory health insurance and old age pension

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systems, mostly managed by government bureaucracies, and subsidies for children are introduced. Thus the welfare state is, besides outright redistribution, which is often combined with these systems, partly a political reaction to changes brought about by capitalist development.

The consequences are on the one hand greater personal freedom of individuals from restrictions imposed by family and society, but on the other hand a rising power of government and of an impersonal bureaucracy limiting personal freedom. The increasing share of government expenditures in gross national product and more and more regulations lead to burdens slowly perceived as unbearable, especially since they weaken efficiency and innovativeness, and thus lower the growth rate of gross national product (Bernholz 1986, 1992; Marlow 1986; Peden and Bradley 1989; Weede 1986, 1990, Tanzi and Schuknecht 1997). Finally a crisis of the welfare state results.

### **V. Reasons for the Emergence and Revival of Free Societies**

We conclude that the combination of a market economy with secure property rights, free markets and rule of law with a free democratic society leads in time because of its very success in creating wealth and its inherent political tendencies to an erosion of the capitalist system and of the constitution of liberty. Faber, Manstetten and Petersen (1997) conclude from this analysis that Public Choice Theory is plagued by "*an intrinsic dilemma*". It "*can explain the rise of a constitutional democracy on the basis of the methodological individualism, but it cannot provide any reason for its continued existence. A constitutional democracy tends to develop into a welfare state ... [which] implies an ever-increasing budget, an expanding bureaucracy and a curtailing of individual rights*" (p. 462). According to them Brennan and Buchanan (1985) and Vanberg and Buchanan (1988) try to solve this problem by constitutional reform driven by a 'constitutional interest'. But this effort leads to a contradiction, for "*it can by no means be relied on that homo oeconomicus will opt for a reduction of the welfare states' activity, and thus commit himself/ herself as a political actor to actions in favour of the constitutional interest*", since these actions lead "*to the loss of short-term advantages, [and] the corresponding gains are uncertain, because they may occur only in the long-run*" (Faber, Manstetten and Petersen 1997, p. 463).

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I would draw a different conclusion. What we observe is not a dilemma of a theory but one of reality. In a sense, what we are looking for, is a solution of the Hobbesian problem. And I suspect that, alike to the squaring of a circle, no definite solution may exist. Thus it may only be possible to approach asymptotically such a solution. We have, indeed, to explain under which conditions free societies are probable to come into existence and under which conditions they can be maintained or revived. I have tried in the Section 3 to specify some of these conditions in analogy to those for a stable monetary constitution. Now I will try to combine some of these thoughts into a more general picture. Let me thus ask first, under which conditions a free society can emerge. Why should the ruling elite in an autocracy agree to strong and secure property rights, to minimal state intervention, to a strong limitation of taxes, and thus of its own powers to command and to take away goods at their own discretion? It seems that the 'New Economic Historians' have tried with a certain success to answer these questions (North and Thomas 1973; North 1981; Jones 1981). They have stressed that 'European disunity has been our good luck'. Feudalism with its many power centers developed during the Middle Ages and a split opened up between religious and temporal powers. A strong rivalry arose among the many rulers to extend and preserve their powers by foreign policy and military endeavours. This forced them to become interested in the well-being and loyalty of their subjects and in economic development to secure a greater tax base and thus stronger armies. However, economic development itself depended on establishing adequate property rights, a reliable legal system, free markets and limited taxes. As a consequence, those states were successful in this fierce foreign policy and military competition in the long run who, by chance or by design, made the greatest progress in introducing such institutions. Thus competition among states forced on unwilling rulers a limitation of domestic powers. The development of competing legal systems, of the rule of law and of property rights was helped not only by interstate competition but also by the increasing separation of church and state, the preventing of a theocracy (Berman 1984). Because of these developments limited government and a pluralistic society arose in Europe as a pre-democratic achievement. First capitalism and later democracy were their progeny.

I have argued elsewhere (Bernholz 1995b, pp. 177-181) that international competition among states is a driving force even until today, motivating rulers like in Japan during the Meiji Era, or more recently Gorbachev and Deng to limit their domestic powers with the purpose to strengthen their

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economies as a base of international power. Whether the reforms are adequate and thus successful is, of course, another question.

Let us next turn to the question, whether a free and democratic society with the rule of law can be maintained or be reestablished after a degenerative development. I agree that there may be some institutions like referenda, popular initiatives, federalism, constitutional courts or the influence of public-minded advisors retarding the inexorable growth of government expenditures (as a percentage of GDP) and interventions (Oates 1972, Pommerehne 1977, Frey and Kirchgässner 1994, Vaubel 1996). Similarly there may be merit in looking for democracies with constitutions of liberty which are self-enforcing (Weingast 1997, Przeworski 1991). But I agree with Mueller (1997) that *"this is obviously a difficult ideal to achieve"* (p. 85). Mueller thus things that *"rather the process of constitution writing must be an ongoing, self-correcting process"* (p.85). I am convinced by looking at the empirical evidence that all such institutions may be able to retard the erosion of the constitution of liberty, but cannot prevent it in the long run. Apart from perceived crises (see below) they seem not to be sufficient to stop the growth of government and the erosion of individual rights, as mentioned above and as evidenced by empirical developments during the last decades (Bernholz 1986, Weede 1986, Tanzi and Schuknecht 1997).

But as we have seen, the situation is different in situations which are perceived by the population and (or?) politicians as crises. In such cases public-minded statesmen or advisors may have great influence, if their ideas succeed against competing simplifying ideologies. Examples are the success of the West German (ordo-)liberals after the catastrophe of the second world war; the reforms by Mrs. Thatcher in Britain after it had lagged more and more economically compared to other European countries and even been overtaken by Italy; or the drastic reforms first taken by the labour government in New Zealand after the extended welfare state based on a mainly agricultural economy had led the country into a deep unemployment, budget deficit and and foreign exchange crisis. It follows, moreover, from the above argument, that a weakening of the relative foreign policy and military position of Great Powers, too, caused by a relatively bad economic performance as a consequence of increasing government activity may be perceived as a crisis and lead to reforms in the direction of reestablishing limited government. On the other hand, as mentioned in Section 3, simplifying ideologies like Nazism, Communism or Religious Fundamentalism may win the day during a crisis. But then they will try to realize the supreme values inherent in their creeds,

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which are more often than not obnoxious to at least substantial parts of a constitution of liberty and a free market economy.

It is obvious that these relationships have yet to be studied much more deeply and that there are still many gaps in our knowledge today. How do we, e.g., define a crisis? How deep has it to be? Under which conditions have fundamentalist ideologies a better chance to succeed in a crisis than sound economic advice?

Finally, is Public Choice Theory indeed unable to explain such political turnarounds? We know that one of the strong forces driving the expansion of government are special interest groups who can be successful because of rationally uninformed voters. The latter do not perceive the burdens they have to carry because these burdens are spread over most of them and are discounted because they may turn up mainly in the future, like ecological problems. The special interest groups, however, are well aware of the sizable benefits concentrated on them. But now, if more and more government interventions favoring interest groups occur, the burdens for ordinary voters increase and will be perceived by them. In such a situation each voter may benefit from one or more government interventions, but the total burden on him by all interventions together outweighs the benefits. Such a situation may be perceived as a crisis. But then it becomes profitable for politicians (especially of the opposition) to propose an election program which contains an implicit logrolling agreement: Each participating group is prepared to forego its special benefits, if so many other groups do the same, that they form together a majority of voters (Buchanan 1991b). Thus a reform towards a more liberal society becomes possible. Recently a formal model addressing such relationships has been presented by Dur and Swank (1997).

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## 24 Merit Goods from a Constitutional Perspective

CHRISTIAN MÜLLER / MANFRED TIETZEL

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### I. Introduction

One of the key aspects in James Buchanan's work is the question of how far governmental action should legitimately reach. In this respect his ideas often stand in conflict with those of the orthodox public finance school of thought as, for instance, with Richard Musgrave's. According to Buchanan's classification, Musgrave represents the insider-Harvard vision of socio-political reality whereas he himself stands for the outsider-Chicago-Virginia-public choice school of thought (Buchanan 1989, p. 291). Both scholars' ideas concerning government intervention appear to be mutually exclusive (see also Hansjürgens 1999). Buchanan emphasized that all governmental action should aim at fulfilling the interests of only the individuals concerned. He stressed 'that in the conceptual derivation of the origins of the state ..., there is no resort to any source of value external to the expressed preferences of individuals who join together in political community.' Consequently, he states that 'the state does not exist as an organic entity independent of the individuals in the polity. The state does not act as such, and it cannot seek its own ends or objectives' (Brennan/Buchanan 1985, p. 22).

In sharp contrast to this Musgrave (1956/57; 1959; 1987; 1990), by means of his notion of 'merit goods', tried to justify even those kinds of governmental regulations which intervene into allegedly distorted individual preferences. In the case of so-called '(de-) merit goods,' paternalistic governments try to induce or even enforce a certain market allocation of private or club goods for which demand is regarded as being 'insufficiently low' or 'too high'. Here the state intervenes, for example, by (wholly or partly) subsidizing (or taxing) the market supply of goods (or bads) or by directly regulating prices to lower or higher than equilibrium levels. The prohibition of production, of marketing and of consumption of addictive drugs is an example of a 'demerit good'; the provision of subsidized opera performances or of 'free' school lunches can be seen as examples of 'merit goods' which supposedly satisfy wants 'society' as a whole considers to be desirable. Although the merit concept as such has remained remarkably confused to this day, its undisputed core is that the 'satisfaction of merit wants, by its very nature, involves interference with consumer preferences' (Musgrave 1959, pp. 13-14).

Notwithstanding these fundamental differences in the underlying normative approaches of Buchanan and Musgrave, it has been suggested that Musgrave's concept of merit goods can be justified by means of a constitutional approach (see Head 1988; Priddat 1993). The purpose of this paper is to examine the correctness of this assertion. First, we try to demonstrate the welfare effects connected with the provision of merit goods. In a second step we shall put forward a coherent definition of the notion 'merit good'<sup>1</sup> which, surprisingly, is still under debate. We then proceed by analyzing the arguments usually put forward to justify their public provision and by confronting these arguments with the normative implications of the constitutional approach. We shall come to a negative answer in all key applications of the merit concept.

## II. The Welfare Effects of Merit Goods

Figure (a) illustrates the welfare effects of the provision of merit goods. The abscissa shows the consumption units of a given commodity  $x_i$ , say, the

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1 For reasons of simplicity, we shall simply use the term 'merit good' to refer to both merit *and* demerit goods.

## MERIT GOODS FROM A CONSTITUTIONAL PERSPECTIVE

number of visits of a museum. The government is assumed to consider this good to be one that satisfies 'merit wants'.<sup>2</sup> The ordinate represents units of another good  $x_j$  which can be thought of as a basket of goods or 'all other commodities'. Let  $x_i$  and  $x_j$  be substitutable, and let  $x_j$  be not inferior. In the following partial analysis, the welfare effects of governmental intervention into the market allocation of good  $x_i$  will be analyzed. The income, substitution and welfare effects on  $x_j$  will be neglected.

The indifference curves  $I1$  and  $I2$  represent an individual's preferences for both these goods at different budget constraints  $Z1$  and  $Z2$ .  $Z2$  prevails as a consequence of an increase in the relative price of good  $x_i$ . As a rational utility maximizer, the individual will demand the combinations  $A$  and  $B$  respectively, given the different budget sizes.

From that the individual's demand curve  $D$  for  $x_i$  in figure (b) can be deduced. Given the supply curve  $S$ ,<sup>3</sup> the household equilibrium is in  $G$  where it consumes  $x_i^G$  units at a price  $P_i^G$ . The individual's total expenses for good  $x_i$  amount to  $0x_i^G P_i^G$ , and the individual's (net) consumer surplus is  $P_i^G GJ$ .

What are the effects of a government's attempt to 'correct' this household's preferences in order to induce an additional consumption of  $x_i^m - x_i^G$ ?

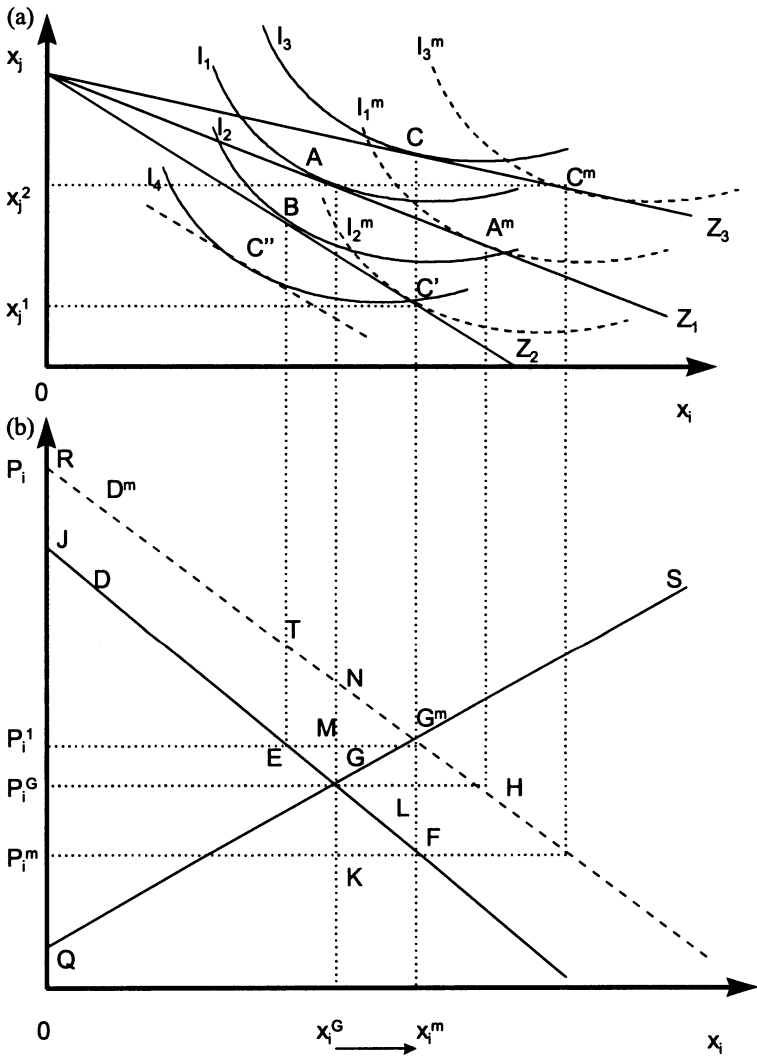
Voluntarily, the household, at a price  $P_i^m$ , will demand the quantity  $x_i^m$  which, however, is only supplied at a higher price  $P_i^1$ . Thus, the overall expenses  $0x_i^m P_i^1$  for quantity  $x_i^m$  have to be subsidized with a total of  $P_i^m F G^m P_i^1$ , since the household is only willing to pay  $0x_i^m P_i^m$ .

Given the condition that the burden of financing this subsidy is not imposed on the consuming household but on the general taxpayer, the consumer surplus rises to  $P_i^m FJ$ . As indicated in figure (a), subsidization results in a reduction of  $x_i$ 's relative price. The budget line then revolves from  $Z1$  to  $Z3$ , thus leading to a new consumption optimum in  $C$  on a higher indifference curve  $I3$ .

2 The case of a 'demerit' good, such as the prohibition of drugs consumption, can be easily reconstructed from the following discussion. Therefore, it will not be treated explicitly.

3 In order to be able to study the welfare effects in a more general framework,  $S$  is depicted with an elasticity of less than infinity, which would be appropriate in the case of perfect competition.

Figure: Welfare and distribution effects of (de-) merit policies



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We are now in the position to explain what is meant by the expression of a 'correction' of individual preferences by governmental intervention: the subsidy induces the household to choose a consumption pattern, *as if* it had preferences for goods  $x_i$  and  $x_j$  represented by indifference curves  $I_1^m$  and  $I_2^m$ . Suppose, these were the household's true preferences. Its demand curve for  $x_i$ , then, would be  $D^m$ , and it would voluntarily consume quantity  $x_i^m$  at a price  $P_i^1$ . This situation is represented by point  $C'$  in figure (a) where the budget constraint  $ZZ$  is tangent to the indifference curve  $I_2^m$ . Having such a preference structure, the household would receive the same consumer surplus as in the case of a paternalistic intervention ( $P_i^m FJ = P_i^1 G^m R$ ), but it would have to bear the full cost of  $0x_i^m G^m P_i^1$ . As a result, the subsidized supply of  $x_i^m$  will cause an inefficient allocation of goods. On the one hand, the household's consumer surplus rises by  $P_i^m FG P_i^G$ ; on the other hand, however, the subsidy  $P_i^m F G^m P_i^1$  exceeds this gain in consumer surplus by  $F G^m P_i^1 P_i^G G$ . In their role as taxpayers the economic subjects stand to lose more than what they gain as subsidized consumers.

An individual household will readily agree with subsidizing the supply of  $x_i$ , as long as its own share of the tax burden does not exceed its willingness to pay  $0x_i^m F P_i^m$ , with the rest of the whole cost being borne by the other taxpayers. The household thus attains a higher utility level on indifference curve  $I_3$ . The subsidy lowers the price that it has to pay for  $x_i$  from  $P_i^1$  to  $P_i^m$ , and the budget line shifts from  $ZZ$  to  $Z_3$ . Meritorious policies are easily enforceable if the tax burden necessary to finance the subsidy spreads over a large number of taxpayers and is individually imperceptible.

The situation is quite different, though, if the household is forced to consume quantity  $x_i^m$  at its full price. One might think of compulsory school attendance, the full costs of which are borne by the students themselves or by their parents. In this case, the household is led to allocate its budget on  $x_i$  and  $x_j$  in a way as represented by point  $C'$ . This, however, does not only pin down the individual on a utility level as indicated by  $I_4$ , which is lower than the level attainable with his budget, but also induces him to choose an inefficient consumption bundle. At the same relative prices, the individual could realize



the same utility level in  $C''$  by spending a smaller amount of money. The gain in consumer surplus from  $x_i$ ,  $KFG$ , is smaller than the utility loss incurred by the additional expenses  $x_i^G x_i^m G^m P_i^1 P_i^G G$ .

In such a situation, the affected households are most likely to resort to resistance and evasion strategies. When, for example, at the end of the 18th century school attendance was made mandatory in Prussia, teachers in the countryside complained about high rates of student absenteeism during seed and harvest times. From the point of view of families with children required to attend school, the opportunity costs of school attendance raised so dramatically during those times that they rather put up with a sanction than to do without their children's help.

### 1. 'Merit Goods' Defined

Given the preceding analysis, we propose to refer to only those governmental actions as 'meritorious' which induce an additional consumption of a good, be it by subsidy or by coercion. Individuals, then, act *as if* they had preferences different from those that they would reveal in an undistorted market. Where merit policies are at work, a government interferes into the market allocation of a good by inducing a consumption pattern different from the one voluntary exchange would have brought about. That is to say that the quantity demanded is no longer solely determined by the individuals' true preference orders and incomes. Rather, it is chosen according to a fictitious 'political' preference order, consumers 'ought' to have in the government's opinion. Market allocation is considered to be 'too exclusive' for merit goods and 'too inclusive' for demerit goods.

Given our definition, not only those goods the consumption of which is to be increased by subsidizing market prices are to be classified as merit goods as, for instance, is often the case with theatre tickets or low-cost housing (merit goods in a narrow sense). Our notion of merit goods also includes goods consumed compulsorily. Seat belts and protective helmets are well-known examples.

Analogously, 'demerit goods' are those the consumption of which should be lowered or kept at low levels according to some regulator's political preferences. Excise taxation of tobacco or alcohol are pertinent examples. As we see it, the notion of 'demerit goods' also comprises goods which are subject to

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a general prohibition of consumption as, for instance, certain habit-forming drugs.

### III. Merit Goods: The Pros and Cons

There can be no doubt that in reality politicians frequently attempt to alter allegedly distorted individual preferences in order to achieve some notion of social welfare. In societies based on less-than-unanimity decision rules, preference correcting 'merit good' policies are widespread phenomena. The mere recognition of this fact, though, does not imply that these policies can be justified from an individualistic perspective. This requires a normative justification of this particular type of governmental action.

Two questions have to be clearly separated in this context: First, it has to be asked if, for the merit good issue in question, interventions into consumer preferences can be justified by reference to some 'defect' in the individual's decision itself (*condition 1*). Most of the literature on merit good issues confines itself to this question. Given some justification of intervention, the means by which such an intervention should be carried out requires closer attention and, related to this, by which actor (*condition 2*). In the following two sections we first examine, whether meritorious interventions meet conditions 1 and 2. Second, we compare the merit good argument to a Buchanan-type constitutional justification of governmental action which, as will be seen, is much more appropriate for public policy evaluation.

#### 1. The Merit Goods Case for Governmental Action

a) The concept of merit goods as lauded by Musgrave is confined to the first question, namely the claim that individual decision-making is defective. The normative presuppositions put forward in favor of meritorious policies are, however, all but clear. On the one hand, Musgrave (1959 p. 14) takes on the 'basic doctrine of consumer sovereignty' as a starting point. This norm may be regarded as one instant of normative individualism according to which the individual is the best arbiter of his own needs (see Hamlin's 1990 illuminating discussion of this principle). As James Buchanan (1986 p. 249) puts it, this principle 'locates sources of value exclusively in individuals.'

Whatever the individuals concerned decide has to be taken as legitimate in a given public policy issue; value judgements 'externally' imposed on them do not bear any normative relevance (see, for example, Buchanan, 1977 p. 142).

On the other hand, according to Musgrave's repeated assertion, the merit concept is meant to achieve more than an individualistic justification for governmental action. Musgrave concedes that a 'position of extreme individualism could demand that all merit wants be disallowed, but this is not a sensible view' (Musgrave 1959, p. 13). In one of his more recent publications on the subject, Musgrave (1987 p. 452) stresses the fact that an 'evaluation of a good (its merit or demerit) derives not simply from the norm of consumer sovereignty but involves an alternative norm.' The postulate of normative individualism is the core of standard normative economics. Therefore, deviations from that premise have to be justified thoroughly. What can be a sufficient reason for forcing an individual with preferences represented by indifference curves  $I_1$  to  $I_4$  to behave as if his preference ordering was represented by indifference curves  $I_1^m$  to  $I_3^m$  instead? Musgrave neither puts forward any such sufficient reason nor describes an 'alternative norm' which could serve as an individualistic justification for such a kind of policy. For some, though by no means all, kinds of merit goods issues, he refers to what he calls 'community values' allegedly held by a society as such (Musgrave 1987, p. 452; 1990, pp. 208-209); in other examples his quotations of Rawls or Harsanyi, for instance, seem to indicate that it is a Kantian norm of universality which he has in mind (see Musgrave 1987, p. 453; 1990, pp. 208 and 210).

b) As it turns out, the concept of merit goods is of little help to determine circumstances under which an overruling of individual preferences can be justified (condition 1). In addition to this, the approach does not offer any guidance as to what kind of regulation can count as meritorious and who should be the regulator (condition 2). No way is offered to select among alternative means of intervention such as provision of information, subsidization or compulsion. Analogously the demand for demerit goods can as well be reduced by means of sales or production taxes as by prohibitions of their production, trade or use. This may well be taken for an invitation to abuse governmental power, as Musgrave himself concedes.<sup>4</sup> Since no restrictions

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4 According to MUSGRAVE (1959, p. 14), 'the satisfaction of merit wants remains a precarious task. Interference with consumer choice may occur simply because a ruling group considers its particular set of mores superior and wishes to impose it on others.'

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on governmental action are offered in the concept of merit goods, even a tyranny of a democratic majority cannot be ruled out as a possibility.

### 2. A Constitutional Justification of Governmental Action

a) One possible way of reconciling meritorious policies with normative individualism might be seen in an extension of the range of the individualistic postulate (see Brennan/Lomasky 1983; Head 1988; Walsh 1990). From the point of view of this wider interpretation, narrow individualism, which is implied by Musgrave's approach, is equivalent to consumer sovereignty. The set  $I_1^m$  to  $I_3^m$  of indifference curves, then, necessarily represents 'external', non-individualistic values which should overrule individual preferences.

Although it is recognized that interventions on the background of this more general kind of normative individualism are irreconcilable with consumer sovereignty, the opinion is being held nonetheless that such interventions are compatible with a position which is individualistic in the wider sense.  $I_1^m$  to  $I_3^m$ , under these auspices, do not necessarily reflect 'external' values, but, under certain circumstances, may be regarded as an individual's *own* 'enlightened' preferences. Unless an individual's process of decision making were in some way defective, he would, in the light of these preferences, agree with the meritorious intervention.

In the last analysis this argument equals a constitutional interpretation of merit wants. In constitutional economics the outcome of a collective decision making process is regarded as fair or justified if a hypothetical consensus of all members of the decision making body can be assumed. This assumption is met if none has to bear (avoidable) costs imposed upon him by others without an adequate compensation. Otherwise the person affected would have a reason to veto the decision. This is equivalent to saying that a consensus on a possible Pareto improvement is conceivable under the condition that all negative externalities are internalized. In a situation like the well-known prisoners' dilemma, all individuals could gain in 'generalizing' their own behavior and in agreeing on a mutual contract in which everyone promises to abstain from free riding. The assumption of a 'veil of ignorance/uncertainty' is a well-known metaphor for this 'generality principle' (see Buchanan/Congleton

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Such determination of wants rests on an authoritarian basis, not permissible in our normative model based upon a democratic society.'

1998). According to this idealized premise of contractarianism, in order to reach impartial and unanimous decisions, one should imaginatively leap into a constitutional decision-making situation in which everyone is ignorant of his future place in society and of his class or status. By denial of all natural and social differences, every individual, by assumption, is able to recognize his 'constitutional interest' (Vanberg/Buchanan, 1988) in a mutual internalization of all external costs.

A key condition for a viable social contract, however, is that everyone abides by his constitutional promises. Constitutional economists regard it as a legitimate role of government to enforce contractual reciprocity. In their view, an intervention is individually justified if 'constitutional' interests are properly represented by indifference curves  $I_1^m$  to  $I_3^m$ . Preference-correcting merit policies, though irreconcilable with consumer sovereignty, may meet the criterion of an extended normative individualism if the individuals concerned can be expected to agree according to their constitutional interests.

Whereas constitutional economics usually deals with problems of *interindividual* competition for scarce resources, attempts have recently been made to apply the approach to what has been dubbed a 'constitutional economics of temptations' (see Koboldt 1995) which Buchanan (1990, pp. 3-4) called for some years ago. This branch of research, sometimes labeled as 'egonomics' (Schelling 1978a), focuses on addiction phenomena and other kinds of temptation situations. This kind of decision-making defects is sometimes modeled as 'intrapersonal prisoners' dilemmas' (see Elster, 1985, pp. 254-55; Kavka 1991, 1993; Moreh 1993). In such situations, by acts of 'self-paternalism', individuals may wish to commit themselves to certain restrictions on their own behavior. 'Personal constitutions' (Koboldt 1995, p. 15), as which these rules can be thought of, are intended to prevent them from making myopic and ill-considered decisions. A well-known illustrative case for such 'weakness of will' phenomena is that of Ulysses who once let himself be bound to the mast of his ship in order to be able to withstand the Sirens' singing (see Elster 1979).

This view suggests that a constitutional 'as if'-test of rules justification is an evaluative criterion of governmental intervention preferable to the concept of merit goods. Moreover, the constitutional approach provides a unified framework for evaluating from an individualistic perspective collective decisions of kinds as different as the provision of public goods, the redistribution of wealth or the shaping of seemingly irrational behavior. However, when-

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ever a constitutional justification can be given, the concept of merit goods is simply redundant.

But where does this argument leave us? Is it correct, as Head<sup>5</sup> seemingly suggests, that a constitutional justification can be given for any kind of a policy which Musgrave takes to be 'meritorious'? We do not share this opinion. In what follows, we shall argue that a constitutional justification cannot be derived for each and every instance of a merit good or a demerit bad, that has been put forward. As we see it, a contractarian justification is not some one-way means of *legitimization* of governmental action but also one of its *limitation*. At the fictitious constitutional level, rational individuals behind a veil of ignorance/uncertainty would more probably agree to assign certain 'insurance tasks' to the government: They would solve the old Hobbesian problem of social order by founding a state in order to insure themselves against assaults on their lives and possessions. Moreover, they would be disposed to establish democratic checks and balances in order to protect themselves from political despotism (see Overbye 1996). And since no individual can know in advance whether he will be poor at the post-constitutional level, each of them would rationally vote for the provision of some minimum level of social security. Quite in the same vein and already two centuries ago, the Hobbesian-spirited 'insurance theory of taxation' considered the state as a mere 'insurance company for political and social accidents' and regarded tax shares as periodically collected 'insurance premiums' necessary to finance its activities (see Lindahl 1919, chap. 2, § 1, and Mann 1937, pp. 105 and 214, for an overview).

The assignment of the role of an insurance to the state, however, does not confer an unlimited license on politicians to intervene into individual decision-making for whatever 'insurance motives'. To every right there is a corresponding obligation which generates costs for the ones obliged. Behind a constitutional veil of uncertainty no one can predict whether, at the post-constitutional level, he will be a golfer in his lifetime. Yet this does not imply that, from a constitutional perspective, government should provide anyone with golf rackets and caddies. In other words, the constitutional insurance analogy can only justify a *minimum* standard of social security (see Murphy 1977, pp. 240-41). The definition of 'rights' will become meaningless if soci-

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5 HEAD (1988, p. 30) emphasizes that the 'multiple preference approach ... provides an individualistic normative theory capable of covering the *entire* range of merit wants and generalized social wants' (italics added).

ety, for reasons of equality before the law (e.g. if swimmers claim the same rights as golfers do, and tennis players insist on being treated in the same way as the swimmers are), simply cannot afford to enact them. In section 3 of this chapter we shall discuss a couple of illustrative examples which, we believe, show that most of Musgrave's examples of merit goods simply exceed these justifiable (and affordable) minimum standards.

b) In addition to this, we intend to show that the constitutional argument developed so far is a necessary, yet not a sufficient condition for governmental intervention. What is to be demonstrated is that, once a *necessity* to intervene has been established (condition 1), an individualistic theory has to indicate *which* kind of governmental action can be seen as an appropriate means of enforcing the legitimate intervention, and, by implication, *who* ought to be entrusted with the enforcement (condition 2). To state a need to intervene does not imply the ability of the state to do so.

Usually, in constitutional economics as well as in the theory of merit goods, condition 2 is passed over in silence. In a prisoner's dilemma game, for example, to which constitutional economists frequently refer as a model of a situation of constitutional choice, there is one unique situation Pareto-superior to the equilibrium. In reality, however, there exists almost always a whole menu of equivalent rules that could make some persons better off without making others worse off. Imagine a number of citizens who, behind a veil of ignorance/uncertainty, share an interest in some minimum degree of redistribution in the post-constitutional society. There are many different alternative ways in which they could realize a Pareto-move as, for instance, the establishment of a governmental insurance monopoly, the introduction of a compulsory insurance or the institutionalization of in-kind-redistributions.

As it turns out, condition 1 focuses on a 'conflict of interests' (see Vanberg/Buchanan, 1989) in constitutional choice the solution of which presupposes a constitutional interest in leaving the initial state of nature common to all individuals. In contrast to this, condition 2 requires the solution of a 'theory conflict', i.e. to find an answer to the question of *how*, and also *by whom*, the legitimate intervention should be carried out.

We believe that normative individualism gives clear answers to both questions: Insistence upon respecting individual freedom of choice is obviously a consequence of a postulate one might label as the *principle of minimal coercion*. To put it in an operational way, this principle reads: 'As much coercion as necessary, yet as little coercion as possible!' The variable to be maximized is 'freedom' which is achieved if there is a choice among 'genuine'

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alternatives (see Vanberg 1982, pp. 56, de Jasay 1991, pp. 17). It would be grossly misleading to call a choice a 'free' one if the utility difference between the first best and the second best alternative is maximal. Both options, then, reasonably cannot be regarded as 'genuine' alternatives. A thief who imposes on his victim a 'choice' between 'Your money or your life!' factually does not leave him a choice. It is only among 'positive' alternatives that one can choose freely. A situation can be regarded as one in which one is not just 'free to choose' but also 'choosing freely', the greater the number of alternatives among which can be chosen and the smaller the utility differences between the first best and the second best options.

Minimization of governmental coercion requires that, from a set of at least two alternative interventions, which could equally serve to heal a given decision-making defect, one should choose the one which least manipulates the number of alternatives and the resulting individual net welfare. This implies, for instance, that problems which can be solved successfully by private action cannot be solved by governmental intervention in a legitimate way since the latter necessarily involves compulsion.

### **3. Some Illustrating Cases**

As far as the concept of merit goods is concerned Musgrave was reluctant to come forth with a thoroughgoing justification. He rested content with an enumeration of cases which he regarded as illustrative examples of justified government interventions. As a first set of cases he considered what he called 'pathological cases' of irrationality and rational ignorance (Musgrave 1987, p. 452) From a constitutional perspective, these examples can be seen as uncontroversial (see, for a more detailed constitutional analysis, Tietzel/Müller 1998, pp. 105-109) and will, therefore, be neglected in what follows. Three further types of meritorious interventions, which Musgrave regards as crucial for his approach, deserve closer inspection. These types consist, first, in redistribution in kind, second, in so-called 'community preferences' and, third, in situations in which individuals suffer from a 'weakness of will' (Musgrave 1987, pp. 452-53; Musgrave/Musgrave 1989, pp. 56-57).

#### **a) Redistribution in Kind**

According to Musgrave a typical case of legitimate merit good policies is that of giving in kind:



'An individual donor may choose to give in kind rather than in cash, because he or she considers certain uses by the recipient as meritorious. Or taxpayers may prefer social programs which provide in-kind aid, such as food stamps, or low-cost housing, over cash grants.' (Musgrave/Musgrave 1989, p. 57)

Musgrave suggests that a society may modify the primary market distribution of income by means of monetary tax-transfer schemes but also by providing everybody with a minimum endowment of in-kind transfers. 'Goods separated out for non-market distribution might then be viewed as merit goods' (Musgrave 1987, p. 453).

In the following we shall take a closer look at two cases which fit this pattern and which, we believe, shed light on the problems involved in Musgrave's argument. Suppose, first, that welfare aid is provided by in-kind units rather than by the more common monetary transfers. Musgrave (1987, p. 452) compares the role of the state to one of a benevolent donor who has a right to freely choose the way in which he offers his 'gifts'. Yet, it is questionable whether in-kind transfers can also be considered legitimate from an individualistic perspective. Head (1988, p. 36), in his quasi-constitutional approach of multiple preferences, answers this question in the affirmative. We believe that this judgement is untenable.

As a contract theorist one would hardly oppose a redistribution by means of governmental coercion *insofar* as it is backed by constitutional 'insurance motives'. One could, for this reason, regard in-kind transfers as fulfilling condition 1. Condition 2, however, is certainly violated by in-kind transfers. One reason for this is that Musgrave's comparison of governmental redistribution to private gifts is mistaken. On the one hand, the donor does not give voluntarily in the usual sense of the word. If redistribution from the rich to the poor is in everyone's constitutional interest, then the state as a donor has an *obligation* to provide the transfer and cannot evade it legitimately. On the other hand, the recipients have a *right* to receive the transfer. The objection raised by Andel (1984, p. 644) that the recipient could easily refuse the redistribution offer, should he dislike it, is invalid. This is because redistributive transfers are not an offer in the usual sense. In common usage, an offer is the supply of a good or service without an obligation. In contrast to this, the donor in this example has a constitutional obligation to make the 'offer'; its rejection by the recipient, therefore, would amount to giving up a legal right. Moreover, the case under consideration is an instance of the aforementioned decisions, in which one does not choose freely. To reject a minimum in-kind-

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transfer of goods, which is just sufficient to survive, implies maximum opportunity costs. Owing to the large utility difference between accepting and refusing the offer, both options cannot count as 'genuine' alternatives. In the extreme, the 'choice' between acceptance or rejection of, say, food transfers can amount to a 'choice' between life and death.

As a second argument, in-kind redistributions are more costly than monetary payments. Food and clothing have to be bought, shipped, stored and distributed; in case of monetary transfers, mere money payments are sufficient. If, on the one hand, the in-kind-transfers are not to be reduced in the amount of this cost difference, the donors have to bear an equivalent increase in taxation. Compulsory contributions restrict a donor's choice opportunities more than necessary; therefore, given the quest for minimal coercion, monetary transfers are clearly preferable to those in kind. If, alternatively, the level of transfers is to be cut back the recipients' choice opportunities are restricted. In-kind transfers and monetary payments could no longer count as equivalent alternatives. Monetary transfers represent an insurance benefit which, at equal cost to the donors, is superior.

What is more, the recipients' needs and tastes will normally differ. Given any pattern of in-kind distributions, there will probably be potential Pareto-moves attainable by exchange. As a consequence, in-kind transfers will usually be inefficient. Given constitutional commitment power, the decision-makers at the constitutional level would, therefore, rationally reject them. In addition to this, exchange is not costless. Such transaction costs reduce the choice opportunities of the recipients. Again, money payments are constitutionally preferable to in-kind redistributive programs. In order to avoid such a result, one might think of prohibiting the sale of in-kind transfers received. This, however, comes only at the avoidable cost of an increased degree of governmental coercion.

In sum, welfare aid by means of in-kind redistribution programs cannot be justified by way of contractarian reasoning. Can one conceive of any other sort of in-kind transfers, say, subsidizing opera performances, which do not suffer from the problems mentioned? Here, the lack of a constitutional legitimization turns out to be even more evident. Opera subsidies do not even take the hurdle of condition 1. Nobody would consider opera visits as being part of an essential minimum for life which alone is justifiable by contractarian reasoning. But even if we went so far as to postulate a general constitutional interest in opera visits, subsidization of music theatres would fail to meet condition 2. For an alternative is conceivable which involves less coer-

cion than subsidizing opera performances, namely direct income transfers to the potential opera visitors. It may go the grain of paternalistic politicians, that direct monetary payments to the consumers leave it to the subsidized individuals themselves whether or not to visit an opera performance or to spend the money for different kinds of amusements. The contractarian principle of minimal coercion, however, does not allow for any other solution.

**b) Enforcement of 'Community Values'**

Other than in the preceding discussion, the indifference curves  $I_1^m$  to  $I_3^m$  depicted in the figure shall now be taken to stand for so-called 'community preferences'. Musgrave regards such allegedly communal wants as another essential application of the merit concept. Regrettably, however, what is exactly denoted by the term 'community preferences' remains rather diffuse. He defines a 'community value' as 'an interest which is attributable to the community as a whole and which does not involve a "mere" addition, horizontal or vertical, of individual interests' (Musgrave/Musgrave 1989, pp. 56-57). On the other hand, and somewhat surprisingly, Musgrave (1987, p. 452) explicitly excludes any relationship to some 'organic' theory of the state, an intuition that suggests itself.

According to Musgrave

'... individuals, as members of the community, accept certain community values or preferences, even though their personal preferences might differ. Concern for maintenance of historical sites, respect for national holidays, regard for environment or for learning and the arts are cases in point. Such acceptance in turn may affect one's choice of private goods or lead to budgetary support of public goods even though own preferences speak otherwise. By the same token, society may come to reject or penalize certain activities or products which are regarded as demerit goods. Restriction of drug use or of prostitution as offences to human dignity (quite apart from potentially costly externalities) may be seen to fit that pattern. Community values are thus taken to give rise to merit or demerit goods. ... Without resorting to the notion of an 'organic community', common values may be taken to reflect the outcome of a historical process of interaction among individuals, leading to the formation of common values or preferences which are transmitted thereafter' (Musgrave 1987, p. 452).

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At closer inspection, it turns out that Musgrave mixes up several different aspects in this quotation. First, in his discussion of historical sites or regard for the environment he refers to pure public goods. Let us take the protection of historical monuments as an example. Behind a veil of ignorance, tearing down a historical building in order to replace it by a modern, more functional one, cannot be justified. In the Rawlsian variant of the veil-of-ignorance assumption, the 'persons in the original position have no information as to which generation they belong' (Rawls 1971, p. 137). Since the monument cannot be reproduced, its demolition would amount to an illegitimate overuse by one generation at the expense of those to follow. In addition to this, protection of historical monuments has the usual properties of a public good. It makes no difference whether the property rights to the historical building are held privately. If a certain historical townscape is to be conserved for the future, private owners of the monuments to be protected are captured in a prisoners' dilemma-type situation: On the one hand, constraints on the use of historical buildings are in everyone's constitutional interest; on the other hand, every owner of a house can gain by building a modern and functional house. In equilibrium, general destruction of historical sites will prevail. As far as public goods are concerned, there is no need to resort to the imprecise notion of 'community values'. Maintenance of historical sites is implied by the conventional public good paradigm.

*Secondly*, when Musgrave considers support for the arts as a merit good, the provision of which can be justified by 'community values', he refers to one special type of 'redistribution in kind'. In that respect, what has been said above may be sufficient. Another aspect allegedly covered by 'community values', the use of drugs, will be treated in the next section in which problems caused by 'weakness of will' phenomena will be discussed.

The only one among the cases subsumed under the category of 'community values', which cannot be readily analyzed in terms of other theories, is the case of prostitution. Musgrave argues that prostitution can be conceived of as an 'offence to human dignity (quite apart from potentially costly externalities)' and, therefore, can be declared as 'demeritorious'. Without a doubt, cases like this one are the classical domain of paternalistic government action. A majority of citizens makes use of the legal institutions of a non-unanimous democracy to impose their personal opinions of 'good life' on others. Musgrave's list could be easily extended. Prohibitions of homosexual actions or of pornography – even if only adults are voluntarily involved and no third party is affected – fit this pattern.

It takes, indeed, an excursion into the metaphysics of 'community values' to justify interventions into the preferences of autonomous individuals. An individualistic-constitutional justification is not available, even if such policies are pursued with the best of intentions. Since in the above examples the set of indifference curves  $I_1^m$  to  $I_3^m$  can in no way be interpreted as reflecting the 'enlightened' preferences of the participants themselves, a constitutional justification would already fail to fulfil condition 1. Admittedly, individuals concerned often tolerate without a protest that the state decides in their place. One of the reasons for this may be found in the collective goods properties such a protest would have. Under certain circumstances even the voters themselves can be expected to vote against their own preferences and for paternalistic collective action. One reason for this could be the existence of a 'veil of insignificance' (Kliemt 1986) which results from the lack of decisiveness from which an individual suffers in large-numbers elections (see Brennan/Lomasky 1983; Head 1988, pp. 30; Brennan 1990). Whatever the reason may be, failure to object to governmental acts of paternalism is by no means equivalent to its unanimous acceptance.

As an interim result we can conclude that a constitutional legitimization can hardly be established, not even for those types of government actions which, according to Musgrave (1987, p. 453), go 'to the heart of the merit concept'. 'Redistribution in kind' generally fails to meet the contractarian criterion of legitimacy. The same is true for the examples of interventions which supposedly are backed by 'community values'. It remains to be seen if merit policies are tenable at least in the case of 'weakness of will' phenomena which Musgrave offers as another potential source of merit legitimization.

### c) The Correction of 'Weakness of Will' Phenomena

There is a multitude of situations in which people succumb to a temptation without taking into account their long-term 'enlightened' interests. Preference theory models this problem of a potential 'weakness of will' on the assumption that a person may have multiple sets of preferences that may be in conflict with each other. Given these divergent preference orders, very different actions may appear to be optimal.

Thaler and Shefrin (1981) model a conflict between short-run and long-run preferences by distinguishing a two-step hierarchy of given preference systems within a single person. An individual is thought of as consisting of a 'planner' and a 'doer'. The planner is farsighted and represents the person's 'enlightened' long-run interest; the doer, in contrast, is completely selfish and

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myopic. The planner within a motorcyclist, for instance, may wish to wear a helmet during every ride. This, on the other hand, bothers the doer who prefers to do without it. Each drug addict wishes to get 'clean'; in the short run, however, when the symptoms of drug withdrawal become overwhelming, he will nonetheless succumb to his addiction. By the same token, an individual may be aware of the advantages of appropriate provisions for his old age; as long as the person is young his short-term preferences may tell him to make different expenses that appear more pressing at that point in time. As a consequence, necessary investments will tend to be suboptimal or, in the extreme case, not carried out at all.

In all these cases a person acts as if he had two sets of preferences,  $I_1$  to  $I_4$  and  $I_1^m$  to  $I_3^m$ , only one of which is in charge at a single point in time. In other words, the welfare effects of a single action, such as putting on a helmet or consuming drugs, may be very different at different points in time. The person in question, then, has a 'problem of self-command, or self-management' (Schelling 1984, p. 87) which 'consists in the fact that he does not act in accordance with his *constitutional* interests (defined over the whole range of decision sequences)' (Koboldt 1995, p. 13). What appears to be utility-maximizing consumption in the short run, is inferior in the long run.

Therefore, the farsighted planner may wish to exercise control over the doer's choices. By way of 'self paternalism', a person, according to the planner's intentions, could choose to impose rules on himself that limit the set of choices the doer faces. In contrast to the institutions considered so far, these rules consist of constraints that are to prevent the person from self-damages ('intrapersonal external costs'). If a government enforces these constraints by coercive measures, according to Musgrave (1987, p. 453), the notion of merit policy applies.

One could imagine that governmental intervention brings about just the decision required by the planner's enlightened self-interest. For instance, the wearing of helmets could be made mandatory or drug consumption could be prohibited. Then, just as a benevolent, omniscient psychiatrist, the government would simply help people to protect themselves against a temporary lack of willpower.<sup>6</sup>

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6 SCHELLING (1978) examined the case of players in the American Hockey League who deliberately chose not to wear helmets although most of them explicitly claimed to favor a mandatory rule to do so. This case differs significantly from the self-management problem considered above. For, many players believed that helmets

According to Head (1988, pp. 15-16), the government can legitimately use taxes, subsidies and any other regulatory or coercive measures in order to solve such individual self-management problems. On the basis of the constitutional approach put forward here, one will not deny the existence of a constitutional interest in the control of self-management problems. Therefore, our first condition can be assumed to be satisfied. This is simply due to the definition of long-term preferences as a person's *own* interests. As far as the policy recommendations are concerned, which may be derived from the diagnosis of a defect in an individual decision, we are much more skeptical than Head is. If coercion is to be minimized, additional information on the dangerous consequences of one's actions should be preferred to government interventions in order to help a person overcome the internal prisoners' dilemma in which he is trapped. If, for instance, friends or relatives repeatedly fail to persuade a motorcyclist to wear a helmet, he should be assumed to have good reasons for not doing so; from an individualistic point of view, these reasons have to be accepted unconditionally. Occasionally, the objection is voiced that, under such a *laissez-faire* regime, other policy holders of the driver's health insurance would have to bear the financial consequences of a potential injury. However, this objection is not well-founded. The insurance companies concerned could simply exempt such cases from their liability. An analogous externality argument could be used in order to prohibit motorcycling, driving a car or cycling entirely. In extreme form, such an argument would immediately lead into totalitarianism.

Given the discretionary power with which the merit concept vests the state, it does not come as a surprise that similar risky activities with a high risk of danger are often regulated in very different ways. In many countries, for example, motorcyclists have to wear helmets even during very short and safe rides; at the same time, mountain climbers, despite the extreme risks

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would cut their efficiency and put them at a disadvantage since they were handicapped by their head protection. Thus, players here are captured in an ordinary prisoners' dilemma-incentive structure. If wearing helmets is made mandatory, all players achieve a joint cooperative situation in which no one has an advantage over the others, and at the same time there is less danger of being injured. Here, compulsion on the players helps to overcome a social, not, however, an intrapersonal dilemma. Thus, according to our above definition, this intervention would not fit the category of merit policies.

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they often face, are not subjected to any similar rules of conduct.<sup>7</sup> By the same token, one might ask why governments usually content themselves with information campaigns in order to prevent the spreading of a disease as serious as AIDS although the risks of unprotected sex may well be as harmful as those of motorcycling without helmets. From such a point of view, the compulsory use of condoms is as legitimate as the compulsory use of protective helmets. The merit concept is unable to exclude absurd consequences such as these since it does not provide clear-cut normative criteria for choosing among alternative measures to re-shape preferences.

As far as *demerit* policies are concerned, government intervention faces additional problems. As a rule, *general* information on potential injuries is entirely sufficient in order to declare the use of head protection helmets or condoms as being 'meritorious'. In contrast to this, in order to counter addiction phenomena properly, a government needs detailed information on which persons are addicted to what extent to alcohol or drugs. Even in one's own circle of acquaintances it is often difficult enough to discover that a close friend or colleague is suffering from alcoholism or drug addiction. Diagnosing a lack of willpower in unknown and anonymous persons from a distance simply amounts to a 'pretence of knowledge'. Friends and relatives are certainly equipped with more information and have a motivation than some government official to persuade a person with multiple sets of preferences to act in accordance with his own long-run interests. On top of this, discriminatory government measures will hardly be reconcilable with the fundamental principle of equal treatment before the law.

Therefore, the only way to solve weakness-of-will phenomena by collective action is to apply demerit policies in a uniform, non-discriminatory way. One might, for instance, think of introducing an excise tax affecting equally all consumers of a demerit good or of prohibiting the consumption of the good entirely. However, such interventions are necessarily inaccurate since it is a characteristic feature of addiction phenomena that only a small fraction of a population is seriously concerned. To tax or to punish the consumption of a drug does not just affect addicts as addressees. As a negative externality, it also restricts the freedom to choose of individuals who are able to deal reasonably with the demerit good.

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7 The explanation suggests itself that the control of motorcyclists is much easier to exercise and consequently more profitable than that of mountain climbers.



A demerit tax on the consumption of a demerit good should ideally be designed as a kind of 'intrapersonal Pigou-tax' in order to internalize the 'intrapersonal external costs' involved. However, such excise taxes face about the same problems as environmental taxes do: They operate accurately only in a few exceptional cases. To individuals who are not addicted and who wish to consume the demerit good in a rational way, governmental sanctioning amounts to an illegitimate compulsion. Addicts, in contrast, will (and can) hardly be deterred from consumption by governmental intervention; for them, the tax or (the expected costs of) a punishment will always be too low. Both kinds of sanctions will serve their purposes poorly. The low elasticity of demand for socially accepted drugs such as tobacco or alcohol is a temptation for revenue-maximizing politicians to tax these goods heavily. From a contractarian perspective, however, the taxation of goods with a low elasticity of demand is to be rejected (see Brennan/Buchanan 1980, chap. 4).

As high prices do not deter addicts from drug consumption, a higher rate of crimes such as smuggling or stealing are to be expected as unintended side effects of taxation or prohibition.<sup>8</sup> Minimal coercion requires that government should not intervene without further preconditions.

If the degree of coercion is to be minimized governmental intervention cannot take on legitimacy as far as individual self-management problems are concerned. For, here, the weakness of will is only a temporary phenomenon. In periods when his long-run preferences prevail, the individual concerned is able to take precautions himself which commit his own behavior at future moments in time to the preferences which are in charge at the moment the rules are chosen. In order to provide for his old age, for example, an individual could sign a savings agreement or take out a life insurance policy the untimely termination of which would carry with it a penalty for breach of contract. In the market place, such a commitment device can even be acquired for free: One promises to pay an amount of money in case one undertakes or refrains from undertaking a pre-specified action; the other party to the contract will agree if the expected value of the money to be paid exceeds his transaction costs. If, nevertheless, one believes, as we do, that governmental retirement insurance is necessary, one has to give reasons other than a potential lack of willpower.<sup>9</sup>

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8 For an economic analysis of drug prohibition and the resulting crime effects see POMMEREHNE/HART (1991) and KOBOLDT (1995, chap. 6).

9 One such reason may be that, without compulsory retirement insurance, each individual has a rational incentive to expect that his fellow citizens will not let him

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A similar argument holds in the case of drug addiction. Nobody is in a permanent state of euphoria. In phases of sobriety the individual concerned can take steps aiming at enforcing his long-run preferences. An effective way to get clean from drugs could be a contractual commitment to the custody of a clinic which legally binds the doctors to hold their patient captive even when he asks to get out. In many countries, however, such self-imposed constraints cannot not be enforced legally; 'Dr. Jekyll can ask to be locked up for his own good, but when Mr. Hyde says 'let me out' they have to let him out' (Schelling 1984, p. 96). A permission to write contracts unchangeable and not terminable forever, though in the individuals' constitutional interests, may be incompatible with some community value held in the merit concept

From a constitutional perspective, one cannot entirely deny the existence of some constitutional interest in drug regulation. This is because under free-market allocation of drugs, it cannot be excluded with certainty that children and mentally weak persons come into possession of drugs. On the other hand, the current system of general prohibition of the use of drugs implies more coercion on more persons than necessary. One could conceive of solutions which would avoid most of the undesired side effects of a general ban on drug use and which would, at the same time, increase individual freedom. Comprehensive information on the potential effects of drug consumption should be provided. A monitored opening of the market for drugs, as suggested by Thomas Schelling, could be accompanied by an institutional separation of the provision of drugs from their consumption. If, during that delay, an individual's constitutional interests come to blot out his short-run preferences, the consumption decision may be finally left untaken completely (see Schelling 1984, p. 104).

### IV. Conclusion

The aim of this paper was to examine if, and to what extent, public policies Musgrave denotes as '(de-) meritorious' can be justified by way of Buchanan-type constitutional reasoning. Our result was negative for all key

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starve to death if he has failed to insure himself. A governmental intervention, for example in the shape of a general compulsory insurance, could be justified by a normal (individualistic) externality argument.

applications of the merit concept although we did not put into question its implicit premise that political agents act as 'benevolent guardians' of their citizens. As widely expressed in the public choice literature, this is anything but self-evident.

'In all', Musgrave (1987, p. 453) sums up the discussion of his conception of merit goods, 'it seems difficult to assign a unique meaning to the term.' From a constitutional perspective, there is nothing to add to this conclusion. For what is defensible in the theory of merit goods is not novel and covered more convincingly by other theories; and what is novel in the theory of merit goods is indefensible from an individualistic point of view.

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## 25 James Buchanan as a Health Economist

MARK V. PAULY

- I. Introduction
- II. Inconsistencies and Consistencies
- III. Is Medical Care a Necessity?
- IV. Conclusion

### I. Introduction

The broad and deep themes of the role of the individual relative to the state, and the proper long-term rules for the conduct of society were James Buchanan's primary areas of interest. He did not write much on the popular events of the day (with the notable exception of *Academia in Anarchy*); he is not a "policy analyst" although he certainly has provided one of the definitive models for the analysis of collective policy. However, one other area of application which did tempt his interest—with that interest responsible for much of the direction of my own career—was medical care. He was the sole author on two essays on medical care, and co-authored a third (with C.M. Lindsay, *The Organization and Financing of Medical Care in the United States*.) In this note I want to comment on the ideas expressed in the two singly-authored essays, placing them in the context of the large and growing body of research on medical economics, while at the same time spotlighting some insights so far neglected which could be discovered with profit by medical economists, and perhaps by the economics profession as a whole. Along the way I will mention the tension that any economist of a reflective nature, of which James Buchanan was the example *par excellence*, feels which confronting an applied and politically charged issue.

The two essays were written nearly fifteen years apart. One was a monograph for the Institute of Economic Affairs, published in 1965, on *The Inconsistencies of the National Health Service*. I will give this essay great credit for stimulating my thinking on the phenomenon which I discovered in research for my thesis was labeled "moral hazard," but I will agree that its insights

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about collective versus market choice as a way to deal with moral hazard have yet to be fully realized.

The other essay was written for a conference in 1989, though not published until 1994, and dealt with what is in fact the root cause of the growth in real health care costs: the adoption of technology that is cost-incurring but quality improving.<sup>1</sup> The fundamental premise of this paper, appropriate for the time it was written, is that the apparently inexorable growth in cost and spending needs to be reined in. It is, I think, it is far to say, a "nervous" paper, as Buchanan tries to reconcile the apparently market-driven rise in cost with his intuition that something has to be done, using collective action if necessary, to stop this process. For much the same reasons, it is a paper I find uncomfortable on first reading, but one that (I will argue) benefits from reflection on the theory and contrast after the fact, about the political and economic developments in medical services financing in the 1990s.

## II. Inconsistencies and Consistencies

Buchanan's view was that the free care provided by the National Health Service in the United Kingdom caused people to seek care relative to two benchmarks. On the one hand, they sought care more frequently than they would have done if they had to pay for it out of pocket. In itself, this encouragement to the use of supposedly beneficial care would not have been regarded as a bad thing, since presumably the reason for enacting the NHS was to encourage people in using care that they formerly eschewed. The paradox was that, if such a motive (presumably related to what might be termed "altruistic externalities") was behind the creation of the NHS, why were voters then unwilling to support a budget large enough to satisfy all demand at a zero price? Buchanan's answer was that, even if the price at the point of use was zero, the tax price for expanding the budget to a level consistent with that demand was definitely not zero; he hypothesized that, at some point, the marginal benefit from spending more would be judged by taxpayers as of less

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1 BUCHANAN, JAMES M.: "Technological determinism despite the reality of scarcity: a neglected element in the theory of spending for medical and health care", in: HACKLER, CHRIS (Ed.): *Health Care for an Aging Population*, Albany, NY (State University of New York Press) 1994, pp. 57-68.

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value than the marginal (opportunity) costs of the taxes they would have had to pay. As a result, taxpayers would choose a budget so limited that demand at a zero price could not be satisfied. The waiting lists, antiquated facilities, and arbitrary limits on care which characterize the NHS are to be expected.

At one level, this "inconsistency" in the NHS is the same kind of inconsistency, apparent in many forms of human behavior, that has been labeled "moral hazard." People are induced to change their behavior by insurance or other devices that reduce risk, and the resulting additional costs may be viewed as a sufficient setting of this behavior not as disembodied (or even specifically game-theoretic) individual or insurance-firm behavior but rather placing it explicitly in the context of collective choice. Moral hazard could be limited by backing up coverage, and imposing patient cost sharing. The British NHS in contrast kept care "free," but imposed supply-side limits, exactly as managed care plans do in the U.S. today.

I believe that, even now, this alternative public-choice formulation is highly valuable. First of all, for health insurance, it is clear that the reason for setting up the NHS (as for Medicare and Medicaid after it) was not some kind of market failure in the middle class private insurance market. Rather, the motivation was that the absence of insurance provided an inhibition to the use of highly beneficial but unaffordable care, especially by lower income persons. Perhaps more importantly, Buchanan's treatment emphasizes the nature of insurance as a collective activity—a voluntary pooling of risk by people who are willing to promise a fixed contribution *ex ante* in order to make large transfers to the unlucky *ex post*. The treatment emphasizes that the insurance-induced increase in the use of services is not necessarily undesirable—it may satisfy altruistic desires, and it may be an unavoidable side effect of risk protection. The problem arises when the protection, or the insurance coverage, is carried too far.

The monograph does leave unexplained why the NHS has so steadfastly resisted patient cost sharing to control use, relying instead on budgetary limits (and now physician "fundholder" payments) which often ration through wasteful waiting time. Ideology, and perhaps some notion of equity, might be responsible. However, especially as the U.S. system itself moved to privately chosen, supply-side rationed managed care, readers of Buchanan's study should not have been surprised to see a backlash at the inconsistencies of those systems developed here as well.



### III. Is Medical Care a Necessity?

The second paper, titled "Technological determinism despite the reality of scarcity: a neglected element in the theory of spending for medical and health care," was presented at a conference on "Health Care for an Aging Population" held in 1989 in, of all places, Little Rock, Arkansas. The irony is not only that the then –governor in residence in Little Rock and his wife would become notorious for their health plan four years later, but also that some of the themes Buchanan sounds in his article were to feature in that debate. The paper is about "technological determinism" in health care—what Victor Fuchs has labeled the technological imperative—the idea that new beneficial medical technology, exogenously generated in bioscience labs and academic medical centers—will be acquired by medical care consensus no matter what the price. (Fuchs has subsequently recanted on this issue, however.) Buchanan apparently accepts this hypothesis, and the consequent "obscene" rate of growth in real medical care spending it seemed to imply. This paper poses two questions: why do individuals behave like this? and should there be some collective actions to limit this individual behavior? One answer that Buchanan gives is that "perhaps, just perhaps" there are "lexicographic preferences." The other is that there may perhaps be a reason to limit collective choices made by individuals. The latter answer, to be sure, is conflicting, since it seems to override his (and our) natural preferences for accepting free market outcomes as in individuals' own best interests.

The notion of lexicographic preferences is simple: Buchanan hypothesizes that people decide to satisfy their preferences for medical services first, and then decide how to spend the rest of their income. The rationale for this assumption is the observation that a person cannot go without care for a broken arm.

If people do "put medical care first" in this fashion, *and* if the cost of medical services rises continuously because of technological change, should the resulting "inflationary" outcome be accepted? Or is there both (a) a basis for overriding it through collective choice and (b) a high probability that the choice would be overridden? In the ironic twist noted earlier, one of the features of the Clinton plan which its opponents found most objectionable was a pre-set limit on the rate of growth of total health spending in the United States, tied to the rate of growth of GDP.

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What does hindsight and health economic research say about this theory? The most obvious (and surprising) empirical fact is that, just at about the time the conference volume was published, the seemingly inexorable high rate of increase in real health spending dropped, most especially in the private sector. The real rate of growth of private health spending per capita fell from about 6 percent in the period 1980-1990 to about 2.5 percent in the period from 1993-1998. This behavior confirmed an aphorism of another Virginia economist, Herb Stein: If it can't go on forever like this, it won't."

It appears, however, that the slowdown in spending growth did not come from slackening the pace of technical change; rather, growth slowed because managed care insurers negotiated discounts on doctor fees and hospital charges, and cut the rate of use of hospitals. The growth rate now seems to be picking up a little, while some think that the rate of technical changes has slowed a bit, but the final returns are not it yet.

What is clear is that there has been a change in the organization of insurance which should permit more precise limitation of technical change. Rather than options only of Blue Cross or commercial indemnity plan, many consumers can now choose from a variety of managed care plans of varying degrees of strictness, including strictness about adoption and diffusion of new technology. As long as legislators do not put barriers in the way, consumers who do not want to pay for some costly new technology should be able to find a health plan that puts the managerial controls in place to limit the technology, and transfers the savings to lower premiums. If there is a technological imperative, the tools now exist to resist it. Buchanan gives the example of a new \$420,000 miraculous treatment for a broken arm that would "cure" in one day. In the current environment, this would be reflected in a choice between two managed care plans, one with a \$2000 normal premium and slow recovery, and the other with a \$2420 premium and instant recovery from a one in 1000 chance of a broken arm. I do not imagine that everyone would prefer the latter insurance, and there are some private insurers who are strict on approving new technology.

There are two more fundamental ideas in Buchanan's article that I wish to discuss: the notion of lexicographic preferences for medical care, and the possibility that citizen-consumers might choose to override collectively the rate of technical change they had chosen individually.

The idea that *some* medical services come before all others in a person's consumption planning – the treatment that will save your life with probability near one (the heart transplant) or will relieve intense pain or dysfunction

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(setting a broken arm) – surely fit into this category. We now know that much, perhaps most, of medical services do not fit this characterization. The definitive evidence is from a social experiment, run by the Rand Corporation, in which some people were bribed into accepting catastrophic (but still decent) insurance coverage and others were offered free care. The former spent 46 percent less than the latter, hardly behavior consistent with consumer beliefs that all or most care is "necessary."

To be sure, there is a concept of "medical necessity" which is alleged to be meaningful to physicians and plaintiff's lawyers. I studied this concept some years ago, and concluded that it either meant "all care of positive net benefit, no matter how miniscule" (which even physicians, if not lawyers, reject on common-sense grounds), or it meant nothing at all. The topic has arisen again in the current debate about regulating managed care plans; a requirement for all medically necessary care to be covered appears likely to be rejected, based in part on inevitable physician conflict-of-interest in defining medically unnecessary care, and in part based on the imprecision associated with the observation "all doctors can agree that a third of care is unnecessary; they just can't agree on which third."

If, upon examination, there is not much substance to the general notion of lexicographic preferences or "necessary care," why does it nevertheless seem to be a perennial and popular notion? Part of the reason is that needy people would *like* to believe that their doctor knows what care is necessary and what is not, despite overwhelming evidence of physician ignorance and subsequent variation in treatment patterns for a given illness. Part is the related points that people feel decidedly uncomfortable admitting that they trade off health against money like any other good. Behind the wheel late at night, when I have put my own life and that of my family at risk by driving rather than flying to Grandma's house just to save on airfares, I may admit to a trade-off—but I am unlikely to do so in polite company.

There is another explanation for this feeling of the irresistibility of technology that I believe may explain part of what Buchanan was trying to get at. James Baumgardner has pointed out that much of technical change or medical services differs from that in other products. For those products, as Buchanan (and Baumgardner) note, improvements in technology can be modeled as a fall in effect price, fully consistent with the conventional economic model. Baumgardner hypothesizes, however, that sometimes things are different in medical care.

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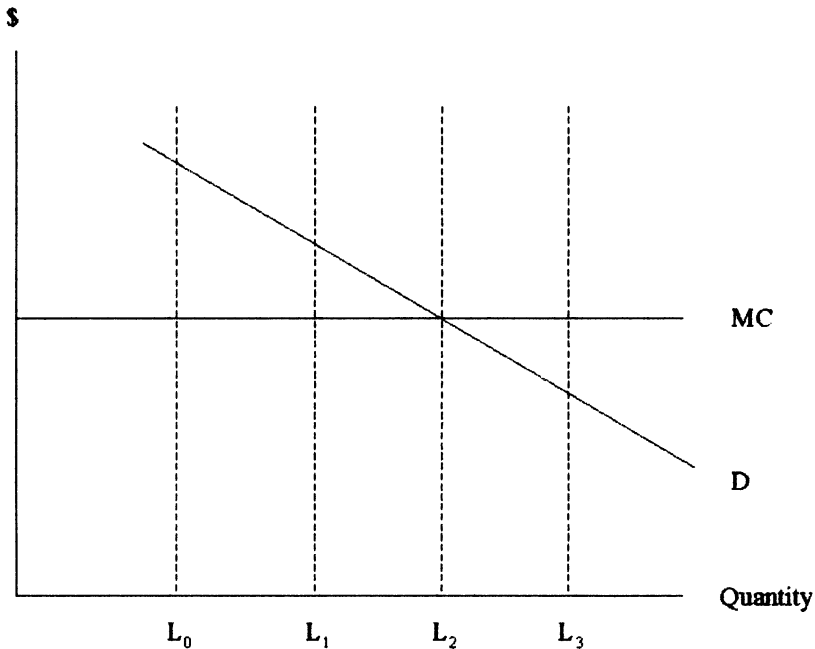


Figure 1

Imagine that the demand curve or marginal valuation curve for "health" (expressed as additional years of survivals) for a person with a serious illness is *D* in Figure 1. Medical care providers can treat this person, providing additional units of health at an assumed constant marginal cost of  $\$MC$ . However, in some cases, it may be reasonable to assume that, with current technology, there is a limit such as  $L_0$  to what science can do. At this point, the person's marginal value of additional health is still very high relative to  $MC$ , but no additional effective treatment exists.

Baumgardner represent what he calls "boundary shifting" technology by a movement of the limit from  $L_0$  to  $L_1$ . To the person with the demand curve *D*, this new technology will appear "necessary," "imperative," or placed before all other items of consumption. At this margin, the consumer will not have adjusted; technology changes price, but the reduction from infinity to  $MC$  is so large as to be qualitatively different from other consumption decisions.

If biomedical science continues to supply boundary-shifting technologies, medical spending will rise. Of course, some technologies will (or ought to) be rejected (such as those that cause a shift from  $L_2$  to  $L_3$ ). But, at least at the

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present in this imperfect world, there are still illnesses causing premature death for which new technology, despite the costs, is desirable.

The key issue here is the source and validity of the demand curve *D*. If it is taken as appropriate (or inevitable), technology which shifts high value boundaries will be adopted. Moreover, people will prefer their insurance to cover it, rather than bear the risk of an out-of-pocket expense. So any challenge to the market-determined rate of technical change must challenge the validity of the demand or marginal valuation curve.

Buchanan suggests one intriguing possible challenge—that people, behind an intergenerational veil of ignorance—might not wish to accept the resource allocation discussions made myopically by each generation. I want to speculate here—and emphasize the word "speculate"—that these might be some reason to challenge these decisions. I consider two reasons: impatience and imperfections in intergenerational transfers.

The impatience idea proceeds from a characterization of new technologies offered by the physician-author Lewis Thomas: that many new technologies are "halfway technologies." They increase in the quantity or quality of life not by preventing or curing, but by palliating, repairing, or ameliorating. The iron lung relative to polio vaccine, and mastectomy or prostatectomy relative to a cancer cure, are examples of such technologies.

When such a technology is introduced into a situation in which previously there was no hope whatsoever, people might prefer to use it immediately rather than wait for the better, and less expensive, alternative. With perfect foresight, this would not happen, but perfect foresight may not always be present. Collectively, however, people might choose to delay the introduction of soon-to-be-obsolete technology.

The other possibility for collective (even constitutional) intervention occurs in a model of multiple generations with productive capital. Total (discounted) consumption might require transfers from one generation to the next. However, a member of the first generation, confronted with the choice between accepting certain death and making a transfer to the next generation versus spending whatever wealth presently available on costly technology with a positive but small chance of extending life may select the latter, especially if there is little concern for heirs and the generations do not overlap much.

Behind a veil of ignorance, an agent who could be a member of any generation might favor banning such extravagances. However, there is nothing special about spending on medical care, as opposed to other "splurges" like a

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round-the-world cruise. People may think that, if you can't take it with you, you should try not to leave anything behind, but such behavior might in principle be rejected in the constitutional calculus. Still, there is no special reason to pick on medical technology—indeed the rate of growth of spending in the last year of life has lagged total spending, and is largely controlled by the collectively chosen Medicare program. Finally, both the presence of concern for heirs and the political difficulty of supporting, in the short term, the constitutional limits just described, weaken this argument.

### IV. Conclusion

Because of the uncertain onset of illness, medical services are an appropriate candidate for insurance. But insurances (of all types, not just medical insurance) raise issues of conflict between the group-organized utility-increasing insurance, in which losers are compensated by winners, and individual insureds' desires to make money off their insurance, whether or not they initially suffered a loss. If it is possible to change one's behavior to increase the insurance pay off, that is, if moral hazard is possible, this conflict is exacerbated.

Buchanan's emphasis on choice of rules before the game is played is an apt metaphor for insurance (as for many things in life) and has enriched our understanding of the fundamental concepts of health insurance. His formulation of insurance as ultimately a collective risk pooling/risk management effort, rather than an individualized purchase, is illuminating. Even his late 80's worries about excessive growth in medical services spending, though currently less pressing, raise some fundamental questions about the roles of individual and collective decision-making in the longest of all runs.

## **Part V**

# **The Moral Dimension**

## 26 Morality and the Political Process

KENNETH GREENE / PHILLIP NELSON

- I. The Phenomenon of Non-Use Value
- II. Moral Behavior, Charity and Political Charity in General
  - 1. Political Charity and Political Positions
  - 2. Political Charity and Loudness
  - 3. Political Charity and Issue Emergence
  - 4. The Existence of Asymmetry
- III. A Study of Voter Behavior
  - 1. The Issues
  - 2. Self-Interest Variables
  - 3. Substitution: Religion
  - 4. Substitution: Community Involvement
  - 5. Occupational Choice
  - 6. Sex
  - 7. Conclusion

The premise of this paper is that morality has a significant effect on voting, where morality is defined by the source of its returns: what others think about one's trustworthiness or its internalization conscience. We will show that morality leads people to advocate more interferences with the market than if simple self-interest dominated their decisions. Many aspects of voting are inconsistent with simple self-interest, where voters are only concerned with the consequences of the policies on which they vote. But self-interest models have been virtually the only fruitful models in the social sciences. Hence, we use an expanded self-interest model where we focus on the returns to trustworthiness in addition to the miniscule returns to policy consequences.

Since this thesis is somewhat different than the ideas dominating the public choice literature, we have organized this paper in a somewhat different way. Our first task is to convince the reader immersed in the standard approach that it might be worthwhile to pay attention. To do this we show that there is an important class of behaviors that cannot be explained by the standard simple self-interest models, but that has the properties assumed in our



model. These behaviors include the phenomena of non-use value in particular and what we call political harity in general. We, then, look at what is known about moral behavior focusing on the most analyzed case: private charity, and see how that knowledge can be applied to political behavior. We then use that knowledge to generate implications about political behavior and test the model. Finally, we discuss policy implications and our conclusions.

## I. The Phenomenon of Non-Use Value

There is strong evidence that some kinds of verbal behavior can neither be explained by the standard narrow self-interest model nor by Nelsons (1994) group interest model. Consider the literature on non-use evaluation by environmental economics: where people are asked how much they are willing to pay as their share of the costs to preserve some feature of the environment that they and their heirs will never use nor see. (The equivalent voting format is at what per family costs would they be indifferent between voting for preserving an amenity plus its costs or against it.) That literature is filled with controversy about whether such non-use values are valid parts of the social benefits of preserving environmental resources. But most agree that the answers cannot be explained by narrow self-interest.<sup>1</sup>

Economists, however, are justifiably skeptical about the relationship of verbal to actual behavior. The returns and costs of the hypothetical vote might be sufficiently different from those of the actual vote to overcome the costs of dissembling. This issue arises frequently in the polling literature. There is consensus that the peculiar variable in hypothetical voting is what the interviewer thinks about me or social acceptability. But the theory developed in Nelson (1994) would predict that social acceptability would produce positive non-use values in actual voting if it produces positive non-use values in hypothetical voting. What others think is important in actual as well as hypothetical voting.<sup>2</sup>

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1 There is, of course, some small probability that any non-user will become a user. Non-use value could simply be a use value times the probability of use. However, these probabilities are often so small and the non-use values given so large that this does not seem a satisfactory explanation of non-use value.

2 The big difference between actual and hypothetical voting is who is likely to know about the behavior, the interviewer or ones friends. For reasons beyond the

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The assessment of positive non-use values to environmental amenities has another obvious property: asymmetry. There are both external benefits and costs in saving an amenity at public cost. The external benefits are others use value of the amenity. The external costs are the costs or taxes that others would incur. If respondents to a questionnaire were simply using a cost-benefit assessment of the amenity and being altruistic, those external costs would be considered as well as the external benefits (Milgrom, 1993). But if the expression of non-use value is not simply an altruistic attempt to take into account net gains of others, then the calculated non-use values may not account for the external costs that others would pay. There is some indirect evidence compatible with the exclusion of external cost in the assessment. Often the non-use value assessed by non-users is higher than the individual use value claimed by users. This means that there is an existence value claimed beyond any use value to users. This is planet love that goes beyond any altruism.<sup>3</sup> At the very least, then, there seems to be an asymmetry between: (1) a concern for others who would be deprived of some benefit because of market processes or individual behavior in non-market areas whether direct or indirect and (2) a concern for others who have to pay for interferences with individual behavior.

### **II. Moral Behavior, Charity and Political Charity in General**

Environmentalism is not the only example of voting asymmetries. All are manifestations of political charity – voting and political advocacy to signal goodness. To understand how it works it is first necessary to understand how standard charity operates. Virtually all charities are the purchases of group

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scope of this article that difference should lead to a higher non-use value for hypothetical voting. Because of the free-rider phenomenon the policy impact of an individual's actual vote will be almost as minuscule as the policy effect of his hypothetical vote. Hence, the importance of what others think in both cases.

<sup>3</sup> Conceivably, the large non-use values are attributable to an inordinate weight placed on the well-being of future generations. But our empirical work in Table 1 we find that those who might be expected to give greater weight to future generations – married people and those with many children – are more opposed to environmental expenditures than others.

benefits at the expense of private costs. The standard explanations for this behavior are (1) altruism, and (2) "warm glow", some unspecified private return to charity. It has generally been recognized that because of the free-rider problem altruism by itself cannot explain charity (Sugden 1982).

The trouble with warm glow is that it is so general as to be devoid of many empirical implications. In particular, it does not specify the activities that generate warm glow. Does it make any sense for the warm glow associated with charity to also operate in the voting arena? If it does, is warm glow asymmetric? Does one get warm glow from voting one way but not from voting another way? Answers require some notion of how warm glow operates. We use as our theory that developed and tested in Nelson (1998): the private returns to charity are some combination of returns to signaling to others that you are trustworthy and returns to "clear conscience": a self-image created by what others would think if they knew your behavior.<sup>4</sup> As shown in Nelson (1998), such behavior acts as a signal because those who get the greatest returns from reciprocity are both the most reliable reciprocity partners and have the greatest incentive to signal that they get the greatest returns.

### **1. Political Charity and Political Positions**

Charity signals that one is trustworthy through sacrifices that less trustworthy people would not make. What is the comparable sacrifice for political positions? Because one's vote has so little impact on the outcome of an election, there would be no costs to a political position far different from one's income-maximizing position. However, one's vote, or more particularly one's verbal behavior associated with one's vote, can have an impact on one's set of friends. One could signal goodness by adopting a position different than that of one's friends at the cost of possibly losing some friends.

Such a signal requires others to know something about one's desired set of friends. But, indeed, they do. They know that a person toward the center of the income distribution is unlikely to advocate greater welfare expenditures to curry favor with the poor, and therefore such actions are likely to signal goodness. They are less sure, however, that any person opposes greater welfare expenditures to signal goodness and not to curry favors from richer peo-

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4 The biologists call charity so motivated indirect altruism. RIDLEY (1996), ALEXANDER (1987).

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ple, who have more favors to bestow.<sup>5</sup> This implies that it is easier to signal goodness by adopting pro-poor positions in contrast to pro-rich positions. It is not clear what is the net effect of groveling vs. being good on political position relative to income, but one can predict that those who have the greatest incentive to signal goodness by political positions will be relatively pro-poor.<sup>6</sup> One signals goodness by advocating externality corrections that involve redistribution toward the poor.

Because both goodness and desired associates are signaled by political positions, the former signal depends very much on what others know about the latter prior to the signal. Suppose others know ones desired associates perfectly. Then, the same pro-poor position would imply both a greater cost and greater return in signaling goodness from a person with pro-rich associates than a person with pro-poor associates. Unless one knew the distribution of how much of the signal people wished to buy, one could not predict whether the former or the latter would be more likely to adopt the pro-poor position. If, however, others have only a very rough prior knowledge of desired associates, then a person with pro-rich associates has higher costs relative to returns from adopting a pro-poor position than does a person with pro-poor associates. In general the greater the costs of signaling goodness, then the less the signal will be used and we predict that those with higher incomes will signal their goodness less by advocating pro-poor positions and more by other methods.

### 2. Political Charity and Loudness

Besides political positions there is another dimension to political charity: loudness - using up time and money advocating a cause. Political advocacy is quite similar to standard charity. Just like standard charity the sacrifice weeds out those who have less interest in signaling trustworthy behavior and the

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5 At first glance, this seems to violate the proposition that competitive pressure will equalize the benefits of relationships among associates. That proposition could still hold with the rich granting more favors to the poor than vice versa, as long as the poor pay a sufficient price by changing their political position and other groveling activities.

6 Table 1 suggests, however, that signaling goodness with political positions dominates groveling. For example, a far higher proportion of whites advocate greater expenditures on Afro-Americans than the proportion of the latter advocating less expenditures on Afro-Americans.

sacrifice is focused on causes that are good from the perspective of the people one wishes to signal. It differs somewhat from charity because signaling goodness is not the only motivation for advocacy. One can also be loud to signal strong group identification when the group is particularly interested in an issue.

But the most serious empirical problem with loudness lies in its similarity to standard charity. There is a positive income elasticity of demand for charity and, one suspects, loudness as well. On that account the pro-rich are likely to make greater political contributions than the pro-poor. But much of political activism is time intensive. The costs to the rich of such activity go up as well as the return so it is not clear that the level of loudness favors pro-rich or pro-poor outcomes. In the empirical section that follows the manifestation of loudness examined is occupational choice: choosing occupations that give platforms to espouse political positions. Because of compensating differentials, the money income of these occupational groups will be lower than it would be otherwise. Therefore, one expects that income to be lower than groups with the same amount of education and the same broad occupational classification. All these variables are held constant in our regressions. If we find these groups to be significantly pro-poor, it would be some indication that loudness also works in favor of pro-poor policies. Whatever problems raised in general by this process, will not apply to our specific analysis.

### **3. Political Charity and Issue Emergence**

There is another source of asymmetry in political charity: any difference between what is socially acceptable and government policy in the initial state: when the issue first emerges as an important political question. The most obvious reason why such a difference can occur is the greater political effectiveness of interest groups defending the status quo than the power of those advocating change. (The former know who will be the losers from the change, while it is less clear who will be the big winners from the change). For example, one would expect that in the initial state as air pollution emerges as a serious political issue the government would under-correct for air pollution even when a majority of people recognize the existence of this external cost. The political power of special interests like the electric utilities would outweigh the power of special interests like the not yet developed scrubber industry. In this initial state most good people would advocate air pollution correcting policies instead of less; while, more special interest

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statements would be generated by those opposed to such externality correcting policy. In this initial state one signals more goodness by advocating more air pollution controls than advocating less.

Now, suppose the government adopts the right amount of pollution controls. One would still signal goodness by being in favor of more pollution controls. People have the belief that this is such a signal, and, in this case, that belief would be self-confirming. Those who are more trustworthy, have a greater incentive to signal that they are trustworthy (Nelson 1998). Hence, there will be a higher ratio of the trustworthy among advocates of more pollution controls.

Now, suppose the government over-corrects. The knowledgeable will begin to advocate less pollution controls,<sup>7</sup> but for a long time it will still pay to signal goodness by advocating greater pollution controls. Suppose at that level of government expenditures some know that the expenditures are excessive, but everybody uses the positions of others in the previous period as their estimate of what is socially acceptable. Since social acceptability is the main return from advocacy, it would pay the individual to go with the flow," to still advocate more pollution controls if that were the position of others, though his advocacy will be reduced by a minuscule amount by his new information. Nelson (1994) shows that long lags in political positions can result and that voting behavior in the 1980's is more closely related to group income at the turn of the century than contemporaneous group income. In general, long lags are characteristic of any activity in which social approval is a dominating source of returns. In sharp contrast market behavior has much shorter lags because the dominating source of returns is individual income.

### 4. The Existence of Asymmetry

Goodness is not dominantly one-sided for all issues. Signaling goodness by defending the poor extends to so signaling by defending any poor group such as blacks or women. But defending the latter group can conflict with family values especially over the issue of abortion. The defense of the latter can also signal goodness. There should be a positive relationship between

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7 This scenario requires more than simple signaling. Both in starting the concern with pollution and, then, starting the concern with over-correction, the knowledgeable must be getting some other return: either a conscience return or some other pay-off to initiating an idea.

those who practice sexual morality as traditionally defined and those who advocate public policies that promote such morality. There are potential costs to those who would advocate morality publicly while being amoral privately: the costs of hypocrisy discovered. One expects trustworthiness in sexual relations to be positively related to trustworthiness in general. (There is a concern with maintaining past relationships in both cases).

Defense expenditures is another issue over which there are conflicted signals. Patriotism signals national identification with expected greater trustworthiness vis a vis members of the majority group. On the other hand, one can signal compassion for the lives endangered by military activity by opposing increased defense expenditures.

### **III. A Study of Voter Behavior**

We can test some of the hypotheses previously developed by running regressions on answers to public policy questions against characteristics of respondents and their families given by data from General Social Surveys 1972-1996 (NORC 1998). Currently, the preferred procedure in running such regressions is parsimony, but those working with the simple self-interest model usually cannot resist the inclusion of at least a few variables that they cannot justify on theoretical grounds such as race, region, or city size. We include a large number of variables. That inclusion is justified by the theory we are testing: that concern with others opinions of oneself is crucial in the determination of voter behavior. There are two main manifestations of that concern: (1) voting like your friends vote, (2) voting to be good. Here we will concentrate primarily on the latter, since the former is more thoroughly examined in Nelson (1994). There, for example, we see the rationale behind the inclusion of the ethnic variables.

#### **1. The Issues**

Our approach is to examine 17 different issues opinions about which will be potentially affected by political charity. We use the commonly accepted liberal vs. conservative characterization of views about these issues. On all these issues one can display one's goodness by being liberal. On a few being

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conservative also offers goodness displaying opportunities. What is crucial, though, is that those groups which have an incentive to be good liberals on one issue will have an incentive to be good liberals on the other issues.

All but one of the surveyed issues dividing liberals and conservatives have a redistributive component. As we have seen, support of the poor is one way to be good. The most obvious of such issues are welfare and aid to the poor.<sup>8</sup> Similarly, more expenditures for blacks on average are redistributive toward the poor. Given the distribution of the costs of those programs, those that are not explicitly pro-poor can be redistributive. Per capita taxes for the rich are greater than for the poor, as are their per capita share of business taxes and the costs of regulation. Therefore government programs for health, education, mass transit, and the environment also can be so characterized. Social security is also on net redistributive toward the poor, at least in terms of permanent income.

There can be cases where the share of returns to government programs of higher-income groups can be greater than their share of the costs. Such programs may include defense and police. In the latter half of the twentieth century the Communist Soviet Union was the main external enemy. The costs to the rich of its success would have been substantially greater than the costs to the poor. An important function of the police is the protection of property and the rich own more than do the poor. The rich are also less likely to be criminals or charged with crimes, so the interests of this latter group will weigh less in their decisions. There is also a positive income elasticity of demand for automobile travel and for the goods transported by trucks. It is not clear whether this more or less counter-balances the share of taxes paid by higher income groups to finance road construction. The primary liberal objection to more roads is a by-product of their pro-environmental position. Roads create more urban sprawl, destroy the aesthetics of the land, and contribute to air pollution. Moreover, if all taxes are fungible, the main form of redistribution that occurs with roads is from urban to rural areas. The liberal base in urban areas will also tend to make them anti-road and so we interpret being in favor of more spending on roads as a conservative position.

The one policy issue surveyed by NORC dividing liberals and conservatives that is not based on redistribution is the abortion question. Do-gooders may be associated with feminist issues in part because women earn less than

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8 NORC asks different respondents whether they are in favor of greater or less expenditures on welfare and on aid to the poor respectively. Since the responses to these two questions were so different we have treated them as separate questions.



men. But more importantly, liberal do-gooders tend to be less religious and less concerned with family values than others, as we show later. Religion and family values are the main under-pinnings of the anti-abortion movement. Because we will be looking at so many regressions,<sup>9</sup> 19 in all, there is a problem with tests of significance. It would be quite likely that a variable will be significant at the 5% level in at least one case just by chance. However, the likelihood that a variable will be significant at the 5% level in at least three cases is .067, and the likelihood of this occurrence in at least four cases is .014. In consequence, we will be slightly overstating the significance of the variable when we state that three significant regression coefficients for the variable implies significance and slightly understating when we state that it is insignificant unless there are four or more such occurrences.

One problem faced in these regressions is what to do about the variables in a regression that are not significant but for which there is a prior case for inclusion. We took two alternative approaches. (1) Including all variables in any given regression that are significant in at least one of the regressions. (2) Including in any regression only significant variables (at the 10% level) in that regression. While the detailed results differ somewhat, the over-all pattern of the results remains the same. (Because of space limitations only the results for (1) are reported here). To maintain comparability among our regressions, we have used ordinary least squares throughout, though probit or multinomial logit would be more appropriate for some of the regressions. Monte Carlo experiments have shown that usually there are not big differences in the results using these alternative techniques especially where sample sizes are very large like ours. Most of the problems with regressions cannot be solved by different techniques. Confidence can be generated only by consistent results over different kinds of data. That is why we have looked at so many issues as reported in Table 1.

## 2. Self-Interest Variables

When economists explore political behavior, they focus exclusively on narrow self-interest: How one would vote if solely concerned with the consequences of the policies voted for. This approach is unsatisfactory theoretically because of the free-rider problem. One's vote has virtually no impact on policy consequences because one's vote is virtually irrelevant in determining

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9 For two of the issues the population is divided into two groups.

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outcomes. Still, narrow self-interest variables do have an impact empirically. Even if moral behavior is operative, the narrow self-interest of the associates whom one is trying to please produces an observed narrow self-interest effect.

The most important narrow self-interest variables we use is income and its square. With the exception of abortion, all of the issues have a redistributive component. In 11 out of the 19 cases the slope of log income at its mean is significant in the conservative direction: only in one case are they more liberal: they are more pro-abortion. In this case the liberal cause does not involve greater government expenditures.

Another self-interest variable is whether a person is self-employed or not. While one expects business and regulatory costs ultimately to be shifted to either consumers or owners of capital, there will be some short-run costs born by current owners of businesses. Furthermore, one expects the self-employed to be more knowledgeable about this tax burden and many self-employed to be imperfectly aware of tax shifting. So one would expect the self-employed to be opposed to increased government expenditures. This is the case. There are twelve cases in which the self-employed are significantly conservative. There are only two cases where they adopt significantly more liberal positions, in each case being opposed to greater government expenditures, first on roads and, then, on the police.

Consider broad occupations as given by the 1968 Standard International Codes. One expects higher income occupations to behave similarly to high-income families, even controlling for family income. One would expect members of these occupations to associate more with high-income families, even holding constant their own income. Furthermore, holding constant occupational income, one expects members of white-collar occupations to do more associating with high-income families. In consequence, one expects such occupations to ape the behavior of high-income groups.

Using Production and Related Workers as the control group, we looked at the behavior of dummy variables for professionals, managers, clerical workers, sales workers, service workers and agricultural workers, including their spouses. All but service workers behave more conservatively than the control group in that each contains at least five significantly conservative coefficients.

Race is another self-interest variable. Obviously, Afro-Americans should be in favor of greater expenditures for Afro-Americans. Also party and conservative-liberal identification and votes for President have a direct self-

interest component for blacks because of party differences over affirmative action. There are other issues that are not explicitly about race, but because of imitation blacks should vote the same way low-income groups vote, even though family income is one of the control variables. Blacks are significantly more liberal on fifteen issues and are significantly more conservative on one issue: crime.<sup>10</sup>

### 3. Substitution: Religion

Now, examine the goodness motivation for voting. The first implication explored is the role of substitution. One can signal goodness by political positions or by a wide assortment of other behavior such as private charity. One can substitute the latter for the former. Substitution dominates over complementarity, and when the latter operates one can usually specify the reason. If the price of the substitute activity goes down, one expects less political charity.

One way to signal goodness is by being a responsible family person. The price of this behavior is lower among members of groups that strongly disapprove of sexual profligacy. One must subtract from the costs of refraining from adventuring the costs of social disapproval. On this account we predict that Fundamentalists will substitute family values for political charity. There is, however, one kind of political charity complementary with sexual probity: advocacy of pro-family-value political positions.

Fundamentalists also find another display of goodness cheaper than do Mainline Protestants: piety. The former have a deeper belief in after-life consequences of present behavior. In particular, attending church would be a cheaper signal for goodness on the part of a Fundamentalist. They, therefore, have less need to display their goodness by political signals.

We try to separate those two incentives by creating a special measure of the pro-family orientation of the narrowly defined religious denomination of a respondent: the sample percentage of those in the denomination who are either married or widowed and have never been divorced.<sup>11</sup> We call this

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10 It is not surprising that blacks want more expenditures to fight crime, though one could not predict this a priori. They have a higher probability of being a victim of crime, but, of course, they have a higher probability of being charged with crime.

11 For denominations with just a few members in the sample such a measure is subject to considerable sampling error. To reduce this sampling error we restricted our measure to denominations with 30 or more members in the sample.

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measure *Fmarried*. We also use a dummy variable for Mainline Protestants called "Main," classifying the NORC narrow denominations using the guidelines developed by Green et al. (1993).<sup>12</sup> Similarly, we would expect those who have no religion ("NOREL") to engage in more political charity than others.

In addition, we include a measure of a person's own pro-family behavior: whether the respondent is married or widowed and has never been divorced. That variable is called *Married*. We also include a variable called *Attend*: the frequency of church attendance.<sup>13</sup> We cannot sign the affect of these two variables on charity a priori. To the extent that one of these variables acts as a substitute to political charity one expects a negative relationship between it and political charity. But to the extent that both are manifestations of a desire to be good, variation in the amount of goodness individuals demand would generate a positive relationship.

Table 1 shows that *Fmarried* has a significant (at the 5% level or lower) impact in the predicted direction on policy preferences in 5 of the 19 cases examined, and does not have any significant impacts in the opposite direction. Being a Mainline Protestant relative to being a Fundamentalist Protestant (Main) leads to a significant effect in the predicted liberal direction in only three cases but there are no significant cases in the opposite direction. Greater values of "NOREL" lead to significant effects in the predicted direction in six cases. There are two significant effects that are opposite from the predicted effect. Those with no religion are more opposed to greater expenditures on social security and on the poor.

Greater values of *Married* lead a person to be significantly more conservative, significantly more anti-abortion, more anti-crime and against more expenditures on the environment. There is one opposite case. For Blacks, *Married* leads to greater support for government expenditures on blacks.

There is a significant positive slope for *Attend* at the means of other relevant variables<sup>14</sup> in eight cases and each leads to the more conservative position. It would appear in both the case of *Married* and *Attend*, but especially in the latter case, that substitution dominates over individual variation in the demand for goodness.

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12 The NORC classifications were occasionally too broad so a few arbitrary decisions were required.

13 As scaled by NORC.

14 There are several cross-product terms in our regressions in which one of the terms is *Attend*.

While the Catholic and Jewish controls are interesting, they are not important for the main hypotheses here and their discussion is reserved for a footnote.<sup>15</sup>

#### **4. Substitution: Community Involvement**

There is also another way to manifest trustworthiness to others: by forming reciprocal relations with others, that is by being an active member of the community. Any variable not associated with an individual's goodness that makes it more difficult to participate in community activities should increase the amount of political charity in terms of our previous analysis.

But, the less people know that one is contributing to charity, the less the incentives to do so. The more relationships one has, the greater the number of people likely to know of one's charitable contributions. As shown in Nelson (1998), that effect dominates charitable monetary contributions. But if fewer people know that one has given to charity than one's political position or activities, the opposite might be the case for political charity. Contributions of volunteer labor are more visible and Nelson (1998) shows they not particularly related to being part of the community.

There is another difference between charity and political charity. The charity signal is favorably received by everybody, while political charity offends those most opposed to the policies advocated. This makes political charity more costly if one is already associating with such opponents. The longer one is involved in the community, the greater the probability that some of one's associates are opponents. The purity of one's associates becomes diluted by other bases for associate formation.

We study several variables that are related to community involvement. Probably the purest such variable is migration. Migration reduces community membership, and the further one moves the less the network of friends and relatives one is likely to have at one's destination. We use two migration variables: whether one is an intrastate migrant (Statmig) in the sense that one lives in a different town but the same state that one lived in when 16, and Contmig, whether one was an interstate migrant in the same sense. There are three cases where intrastate migrants are significantly more liberal than non-migrants but one case where intra-state migrants are more conservative than

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15 Their coefficients and those for other minority religions lend weight to the idea that minority denominations are more liberal.

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non-migrants. Interstate migrants are significantly more liberal in six cases significantly more conservative only in one case.

We also posit that the age variable acts dominantly as a community membership variable: one can establish a reputation through present and past participation in the community.<sup>16</sup> The slope of the age variable at its mean and the mean of other relevant variables is almost always significant. There are thirteen cases where older people are more conservative; three where they are more liberal: They are more Democratic, vote for Democratic candidates for President and are in favor of greater expenditures on mass transportation.<sup>17</sup>

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16 Conceivably, however, age could also be an information variable.

17 Some of these results require explanation. How could older people support all of the important positions associated with Republicans (Mass transportation is not that big a political issue) and still end up supporting Democrats? The answer, we believe, lies in a likely interpretation of the social security question in the NORC survey. NORC asks whether expenditures on social security should be increased, decreased or remain the same. We scale the respective answers to this questions as 3, 1, and 2 respectively with dont knows being assigned a 2. Not only are older people more opposed to social security on this scale but the aged are particularly opposed. (Age squared is significantly negative). Nor do these results depend upon the inclusion of all the other variable we employ. The age variable has a significant negative simple correlation with support for social security. On its face these results are inconsistent with political wisdom about the aged and social security. It is not unreasonable for many people to interpret the social security question to mean whether individual benefits to social security should be increased more than they would do so automatically. Given that interpretation, there is a way to explain our results. Most of the social security debate has focused on the fiscal difficulties of maintaining social security benefits including the COLA given an aging population. Even social securitys staunchest advocates in this debate do not advocate an expansion of benefits. Those who are in favor of maintaining the benefits including the COLA would be counted in our survey as 2's. They would be relative opponents of social security, since the mean value of the answers is 2.45. We expect the social security regression to be dominated by determinants of whether people are aware of this debate or not, rather than narrow self-interest or goodness variables. That expectation is confirmed by a closer look at that regression, which we postpone until we discuss all the variables entering into our regressions. Certainly, the aged would be likely to be among the most informed about this debate. If the aged support social security, the rest of the puzzle is easily answered. Support for the Democrats among older Americans flows from the Democrats perception as the pro-social security party. The mass transit support of older Americans probably flows from the higher rate of disabilities among that group that limit their driving. An alternative explanation for older people supporting Democrats is a confusion between the effects of age and cohort effects. Democratic party identifica-

Some of the other variables that we have previously discussed also have a community involvement component. One expects community involvement to be positively related to church activities. Previously, we interpreted the negative relationship between church attendance and political charity and the positive relationship between no church affiliation and political charity to be piety acting as a substitute, but it could be due to community involvement. That alternative hypothesis would seem to be required to explain a seeming paradox. Church attendance is the single most important variable (Nelson 1998) explaining standard charity for non-church based contributions as well as contributions through the church, and yet it produces less political charity. The usual altruism explanation for both standard charity and political charity makes no sense in terms of this result.

There is another community-involvement variable: city-size. It is harder to be an active member of the community, the denser its population. The anonymity of the city has long been recognized. City residence will also make a person more liberal because his neighbors will be more liberal and may consist of more blacks, migrants, singles, and faithless.

Suburbs also create unfavorable conditions for community involvement, since a substantial portion of their population commute long distances to work with a resulting separation of the social life of work and residence. Holding density constant, suburbs should have less community involvement than other city types. Suburbanites are also affected by the attitudes of central city residents, since the latter are often the work associates of the former. This too should make suburbanites more liberal.

It is not surprising that city size categories make a significant difference in the predicted direction for most of the issues investigated. In three of the cases: mass transit, roads, and the environment, there are clear differences in self-interest by city-size categories. But the city-size effect is significant for most of the other issues as well. There are thirteen issues where those in the largest central cities (LRCIT) and seven where those in the next largest

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tion is declining significantly over the years 1972-96. This would tend to generate a positive age effect not controlling for cohorts, which we do not. However, there is no significant decrease over time in Democratic (President) voting percentages over this time period. Furthermore, there is no significant relationship between the betas (the standardized regression coefficients) for Years and the age slope, when one compares issues in such a way that more conservative positions are given positive values. In general, this last result suggests that the age effect over all our issues is not dominantly a disguised cohort effect.

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(SCCIT) are significantly more liberal than those in rural areas, the control group. There are three issues for which no city-size category is significant – social security, aid to the poor and expenditures for blacks (among blacks). For roads all city size categories are significant except large central cities (a surprising exception). For police expenditures, results are reversed, and significantly so. The larger the city the more its residents adopt the conservative position – more expenditures to fight crime. The obvious explanation is that large cities have a more serious crime problem.

For six issues the suburbs of the largest cities (LSURB) are significantly more liberal than the comparable density group – other urban: the environment, welfare, abortion, education, city expenditures, roads, and mass transit and this is also true for the suburbs of the next largest cities (SSURB). Three of these positions can be explained by self-interested connections to the city: the environment, city expenditures, and mass transit. One is just the reverse of what one would anticipate in terms of self-interest: roads. Commuters are heavy users of roads as well as mass transit. For party identification suburbanites are more conservative than residents in the category other urban.

An alternative explanation for why the lack of family values and community involvement makes a person more liberal is that there will be fewer people to turn to in case of disaster if one is not in close touch with family or other people. So, one will be more interested in government programs as a security blanket (Borcheding and Holsey 1996). However, none of our results imply that this process dominates. There are four issues where insurance considerations could be important – health, social security, aid to the poor, and welfare. Married has an insignificant coefficient for all four. Fmarried has a significant coefficient only for aid to the poor. So too for the migration variables, but that significant issue – social security – has the wrong sign. Positions on social security are not significantly related to city size, nor are positions about aid to the poor. City size categories have less effect on the health issue than on most other issues. Only welfare positions are strongly city-size related.<sup>18</sup>

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18 City-size variables also have another feature that would be difficult to explain with the alternative hypothesis. Not only does the current city size in which the respondent lives make a significant difference in political positions, but so too does city size of the respondent when 16. For three of the issues - aid to the poor, health, and parks – there are more significant coefficients for the latter than the former. For four others the lagged city coefficients are roughly equal those for current cities: the environment, crime, education, city expenditures (for those not in central cities). There



There is one community involvement variable that is positively related to political charity: the number of organizations to which one belongs (Memnum). It has a significant liberal coefficient in seven cases and there are no significant conservative coefficients.

The difference between Memnum and the other community involvement variables is that Memnum can be a function of a persons activism rather than simply influencing the activism.<sup>19</sup> One may join the ACLU or the Sierra Club in ones desire to be good. Naturally one may join the John Birch Society but the positive effect of Memnum is important evidence for the asymmetry of political charity: that there is a greater return to being a good liberal compared to being a good conservative.

### 5. Occupational Choice

We hypothesize that one of the determinants of occupational choice is the desire to display ones goodness. Those occupations that provide a platform for espousing good views or an opportunity to fight injustice will tend to be chosen by those with such views and those convinced about these injustices. We concentrate our attention on college and other teachers, journalists, clergymen, and lawyers. Our technique is to look at the regression coefficients of the dummy variables associated with whether one or one's spouse is a member or not of the respective occupations, controlling for all the other determinants of political preferences. We define college teachers by industry rather than occupation because there is a serious problem with the occupational definition in this case. Many college teachers would not so classify themselves. They might call themselves economists, physicists and so forth. However, use of the occupational definition does not change the essence of our results.

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are, however, five issues on which the current coefficients are bigger than the lagged ones: welfare, abortion, party identification, Presidential votes, and mass transit. In NELSON (1994) it was shown that imitation produces lags in voter response to underlying conditions. When a person moves from a city size, it no longer affects the reality he confronts, though it might still affect his family. It is hard to believe that the weight he gives to the family he left behind will be more important than the weight he gives his current family. His attitudes move with him, however, and it is possible that early attitude formation could be more important than what happens later.

19 For ease of exposition we do not always make the existence of these control variables explicit.

## MORALITY AND THE POLITICAL PROCESS

It comes as no surprise that college teachers are liberal. In no other occupation are there so few constraints placed on advocacy. Academic freedom virtually removes employer monitoring of college teaching. College teachers are significantly liberal on nine issues, and there are no issues on which college teachers are significantly more conservative.

Others have found college teachers even more liberal (Trow 1975). Our regressions do, however, reveal an important consequence of the liberal proclivities of academics. The political position of those who have been to college is affected by what their teachers had to say long after they leave college. There are twelve issues on which people adopt significantly more liberal positions the greater the number of years they have attended college.<sup>20</sup> However, there are four cases in which those who have been to college are significantly more conservative, and that is enough cases to make it unlikely that these latter results are just attributable to chance.

But is not surprising that there are some issues about which years of college make one more conservative. The greater one's education the more likely one associates with others of higher income. Through imitation this should make those who have been to college more conservative even controlling for their own income. We have seen that prediction work by broad occupations. In Nelson (1998), it is shown to work by ethnic groups. We are not able to predict a priori whether the income associates or the college experience effect will dominate. However, two of the liberal positions produced by college do not meet resistance from high-income groups, who are also pro-abortion and neutral as far as increased expenditures on education.

Though our theory does not predict the sign of the year of college slope, it does yield more subtle predictions. Holding constant the general age effect, one expects years of college to have a greater liberal effect the younger the person. A college student starts out being indoctrinated by teachers and peers. He, then, starts associating with people with higher incomes, and gradually moves toward the political position of that group. To test this hypothesis we create a cross-product variable: age times years of college: (AGECOLYR.) There are six cases where AGECOLYR is significant in the predicted direction and only one case where it is significant in the wrong direction: parks, hardly one of the burning social issues emphasized on campuses in the second half of the twentieth century. There is also one issue for which both income and college teaching have the same sign: abortion. On that basis there

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<sup>20</sup> Evaluated at the mean of age, the other component of the one cross-product term involving years of college.

is no clear prediction about the sign of AGECOLYR. In the abortion case older ex-college students are significantly more conservative.

There is one more testable implication about the effect of college indoctrination on the political position of those with college experience. One would expect those with college to be most liberal on those issues on which college teachers are most liberal and least liberal about those issues on which those with higher income are least liberal. Indeed, this is the case. Since one expects the slope by issues to be sensitive to the variance by issue, we compare standardized regression coefficients – betas – by issue. We then regress the beta for years of college (Colgo) against the log income slope (Insl) and the college teaching slope. The results:

$$\text{COLGO} = .0087 + .367 \text{ INSL} + .241 \text{ COTEIN}$$

(3.58)            (3.18)

With 19 observations, these t values (in parentheses) are significant at the 5% level.<sup>21</sup>

All of the results on college teaching possibly could be explained by an alternative hypothesis: knowledge makes one liberal. When does knowledge end and indoctrination begin? Are classes devoted to information about the benefits of government activity without a concern for costs indoctrinating or transmitting knowledge? Economists – the one group that focuses on cost-benefit analysis – are the most conservative group of social scientists (Lipset and Ladd 1971). This strongly suggests that at least some of the college effect is attributable to indoctrination. In addition, the aged are more conservative. To the extent that this is attributable to the greater knowledge of the aged, this result is inconsistent with the knowledge explanation.

Teaching at lower than the college level (LOWTEACH) also offers a platform for the espousal of political positions, but the platform is much lower because of the constraints placed on these other teachers by lesson plans and more careful monitoring of their activities. They are significantly more liberal on three issues.

Increases in years of below-college education (NCOLYPR) make people significantly more liberal on six issues and it makes them significantly more

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21 There is, however, a possible problem of simultaneity in using a least-squares regression procedure. Fortunately, the respective simple correlation coefficients are all significant at the 5% level, so whatever the causal process, there does seem to be a relationship by issue between the effect of years of college and the effect of college teaching and the effect of income.

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conservative on four issues. In the absence of an indoctrination effect, increases in years of below-college education would be positively associated with conservative positions because increases in education lead to greater associations with people with higher incomes. The only reason we know why this effect does not dominate is the possible indoctrinating effect of below-college education.<sup>22</sup>

Educational indoctrination together with income imitation should make older less than college educated people more conservative (AGENCOLYR), even controlling for the general effect of aging on political positions. This prediction is significantly confirmed in six cases, while there are four cases in which the sign of the age-years of non-college education coefficient is significantly in the opposite direction. This is not a ringing confirmation of the below-college indoctrination hypothesis. Of all of our tests the only one that suggests this indoctrination is the more liberal stance on a substantial number of issues of those with more below-college education..

Writing – and journalism in particular – is another occupation that could provide platform for do-gooders. Because of the relatively small sample size

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22 One might question the approach of this section to indoctrination. We have focused on the regression coefficients by issues of college and non-college teachers, holding constant a considerable number of variables. This procedure is appropriate in determining whether do-gooderism explains any part of the political position of these occupations. One would assuredly want to control for the other determinants of political position. However, the issue is somewhat different if one is concerned with the effect of teachers on their students. What difference does it make if a college teacher is made more liberal by his political charity, if, on net, he is conservative because he is in a higher income group? Whether he makes students more liberal or more conservative would seem to depend solely on whether he is liberal or conservative on net relative to the population as a whole. The appropriate measures of that characteristic would be the simple correlation by issue of measures of his political position and job status. There is, however, a serious problem with this argument. It does make a difference why a college teacher is a liberal. Those who seek to be college teachers in part because it offers a platform for their political views are more likely to use their teaching as a platform. For one thing they are more likely to teach subjects where political views are relevant. Still and all non-activist conservative professors might have some impact in influencing the political position of their students. Both the simple correlations and the regression coefficients would appear relevant in predicting the influence of teachers. Fortunately, the simple correlations yield results similar to the regression coefficients. In terms of the former, college teachers are significantly more liberal on nine issues. There were also nine significantly liberal regression coefficients for college teachers, though the lists are not identical.

of journalists in the NORC study, our study would be expected to yield only limited information on this subject. Writers, including journalists, are significantly more liberal than others on four issues. They are not significantly more conservative on any issues.

Some lawyers might choose that occupation to help right the world's injustices. There are four cases where lawyers are significantly more liberal and no cases where they are more conservative.

Clergy is another occupation where sermonizing goodness is a determinant of occupational choice. But in this case the possible range of sermons is large. A clergyman can focus on piety and family values as well as social issues. In consequence, it is not clear, a priori, whether clergymen, in general, will be liberal or conservative. Our study yields only one significant coefficient out of nineteen.

## 6. Sex

A variable that is consistently significant issue after issue is sex. There are 13 issues where males are significantly more conservative than females; two where they are significantly more liberal: crime and parks. It is easy to understand the latter results. Women are more likely to be victims of crime, and less likely to be criminals. Men probably use parks more than do women.

Why are women more liberal than men? Conceivably, the underlying cause is women's lower wages. But families in which adult women are a part probably do not have dramatically lower income than the families including adult males. One would also expect the imitation effect to be much less with a sex variable than with most of the other variables we employ. In general, imitation magnifies any underlying regression if one associates dominantly with people like oneself. Women and men do a lot of associating with one another. Yet, the sex variable has more significant liberal coefficients than does income itself. (13 compared to 11).

The only explanation for this sex difference that we can conjecture is not really part of our central theory. We hypothesize that this difference is attributable at least in part to a biological reason: women are more compassionate than men because compassion is a useful tool for child-rearing. Compassion is a word often used in defense of liberal positions, and it would seem to have particular relevance to the liberal position on crime and defense, as well as all the pro-poor positions.

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### 7. Conclusion

This paper provides evidence for two propositions: (1) That political charity is asymmetric, that do-gooders adopt pro-poor political positions and positions opposed to the preponderance of special interests in the initial state; (2) that political charity has a profound effect on political behavior. We test two hypotheses that are generated by these propositions. (1) Substitution: when the price of alternative ways of showing goodness goes up, people adopt more liberal political positions. We show that increases in the price of personal probity, piety, and community involvement increase liberalism. (2) Occupational choice: liberals choose occupations which provide a platform for their views. College teachers, writers, and lawyers tend to be liberals, but there is not strong evidence that this is also true for non-college teachers.

Of course there are alternative hypotheses for some of our results, but none that we know to explain the whole pattern. That is not surprising, since there has been only one alternative idea developed: simple self-interest. Because of the free-rider problem that idea has serious problems in explaining political behavior.

# KENNETH GREENE / PHILLIP NELSON

**Table 1 : OLS Regression of Support for Government, Political Parties and Candidate**

INDEPENDENT VARIABLE	PROWELF	PROPOOR	PROHEAL	PROED	PROENV	PROSOC	PROARMS
DEPENDENT VARIABLE							
FY	-1.24E-01 ***	-8.67E-02 ***	-4.33E-02 ***	-4.49E-03	-3.01E-02 ***	-7.34E-02 ***	1.74E-02 **
FYS2	3.35E-03	-1.62E-02 ***	-1.42E-02 ***	-9.98E-03 ***	-1.60E-02 ***	-2.43E-02 ***	5.87E-03 *
FYSLOPE	-1.26E-01 ***	-7.57E-02 ***	-3.37E-02 ***	2.25E-03	-1.93E-02 ***	-5.70E-02 ***	1.34E-02 **
SELF	-3.70E-02 ***	-1.04E-01 ***	-5.70E-02 ***	-5.22E-02 ***	-4.75E-02 ***	-7.06E-02 ***	-1.57E-02 ***
PROF	-2.36E-01 ***	-1.29E-01 ***	-1.13E-01 ***	-7.53E-02 ***	-1.73E-01 ***	-5.87E-02 ***	7.85E-02 ***
MGM	-4.69E-02 ***	-1.96E-02 ***	-1.13E+04	-3.18E-02 ***	-5.71E-03	-7.27E-03	1.95E-03
CLERK	-4.36E-02 ***	-5.39E-02 ***	-8.45E-03	1.42E-03	-9.09E-03	-2.36E-03	-1.06E-02
SALES	-5.18E-02 ***	-3.88E-02 *	-1.40E-02	-7.44E-03	-3.68E-03	-2.12E-02	1.76E-02
SERVE	2.23E-02	-3.81E-04	-1.96E-03	-8.82E-03	4.37E-03	1.93E-02	2.31E-02 *
AGR	-2.44E-02	-3.49E-02	-8.97E-03	-3.50E-02	-6.59E-02 ***	-4.61E-02	-8.59E-02 ***
BLACK	4.76E-01 ***	2.89E-01 ***	1.49E-01 ***	1.57E-01 ***	6.54E-02 ***	1.05E-01 ***	-1.85E-01 ***
UNION	-1.35E-03	-6.60E-03	1.32E-02	1.59E-02	8.07E-03	2.93E-02 ***	-6.17E-03
GOVNR	8.15E-02 ***	0.00E+00	3.27E-02 **	-4.34E-03	3.33E-02 **	0.00E+00	-1.22E-02
MAIN	-1.19E-02	2.19E-02	1.55E-02	-5.15E-03	2.22E-02	-1.63E-02	-1.26E-02
JEW	2.16E-01 ***	8.42E-04	6.41E-02	1.81E-01 ***	8.20E-02	5.45E-02	-1.58E-01 **
JSLOPE	1.33E-01 *	6.95E-03	9.60E-02 *	1.47E-01 ***	9.71E-02 *	2.21E-02	-7.90E-02
CATHOLIC	2.02E-02	1.10E-02	2.13E-02	1.84E-03	2.69E-02	2.57E-02	-2.14E-02
CSLOPE	4.72E-02	-2.28E-02	1.57E-02	1.05E-02	5.32E-02 *	2.53E-02	-7.99E-02 **
NOREL	1.52E-02	-1.21E-01 ***	-2.13E-02	-5.36E-04	1.56E-02	-7.80E-02 ***	-1.05E-01 ***
OTHREL	1.19E-02	-5.33E-02	9.29E-03	6.51E-02 *	4.07E-02	-6.19E-02	-1.06E-01 **
ATTEND	-1.12E-02	1.88E-02	-1.27E-02	-8.50E-03	-2.72E-02 ***	-5.37E-03	1.67E-02 *
ATTENDSL	-1.03E-02 ***	-2.11E-04	-1.13E-02 ***	-5.55E-03 ***	-8.02E-03 ***	-9.66E-03 ***	4.85E-03 **
PATT	5.47E-03	-2.65E-02 **	-4.31E-03	1.08E-04	8.06E-03	-2.50E-03	-1.18E-02
CATT	6.76E-03	-8.49E-03	-1.42E-03	2.18E-03	6.61E-03	-9.70E-05	-1.47E-02 *
JATT	-2.08E-02	1.54E-03	8.01E-03	-8.39E-03	3.80E-03	-8.12E-03	1.99E-02
FUNDAT	-1.99E-03	-1.15E-04	2.25E-03	1.29E-03	6.40E-03 ***	-1.31E-03	-5.88E-04
FYINCOME	9.59E-02	1.15E-02	-3.77E-02	-8.13E-03	-3.95E-02	-8.73E-02 *	-2.02E-01 ***
FMARRIED	-1.54E-01	-4.99E-01 ***	-1.39E-01 *	-1.02E-01	-1.99E-01 **	-1.65E-02	3.70E-01 ***
MARRIED	-3.30E-03	-2.16E-02	1.13E-02	5.43E-03	-3.52E-02 ***	-1.65E-02	3.12E-03
CHILD	-2.07E-02	8.39E-02 ***	6.05E-03	3.23E-02 **	4.54E-03	4.17E-02 **	2.39E-02
NCHILD	3.14E-02 ***	-2.44E-02 ***	-5.90E-03	-8.41E-03	-1.03E-02 **	-1.52E-02 **	-3.78E-03
STATMIG	-2.10E-03	1.99E-02	3.85E-03	1.86E-02 **	9.91E-02 ***	-9.82E-03	-2.27E-02 **
CONTMIG	1.13E-02	3.32E-02	1.31E-02	2.21E-02	3.42E-02 ***	-3.26E-02 ***	-1.25E-02
MIGSL	5.40E-03	2.73E-02 *	9.03E-03	2.06E-02 ***	2.35E-02 ***	-2.26E-02 **	-1.70E-02 *
CLERGYSL	1.24E-01	-4.37E-02	3.29E-02	1.93E-02	-1.53E-02	-1.37E-02	3.88E-02
AGE	-1.79E-02 ***	-3.55E-03	1.56E-02	5.63E-03	-6.71E-03	1.90E-02 ***	6.29E-03
AGE2	9.35E-05 ***	-4.76E-05 *	-1.30E-04	-7.68E-05	3.87E-05	-1.71E-04 ***	-9.47E-05 ***
AGESL	-2.41E-03 ***	-3.30E-03 ***	-1.10E-03 ***	-5.32E-03 ***	-8.21E-03 ***	-6.34E-04	4.41E-03 ***
MEMNUM	-3.36E-04	1.19E-04	1.02E-02	1.27E-02 ***	1.02E-02 ***	4.00E-03	5.30E-04
SCCIT	1.41E-01 ***	3.28E-02	4.49E-02	7.24E-02 ***	9.88E-02 ***	5.04E-02 *	-5.25E-02 **
SCCIT2	4.98E-02 ***	-1.94E-02	-9.47E-03	1.48E-02	2.90E-02 *	1.72E-02	-1.12E-02
SSURB	5.21E-02	-1.50E-02	-2.58E-03	2.86E-02 **	4.82E-02 ***	2.54E-02	3.16E-03
LSURB	8.85E-02 ***	-1.26E-02	5.14E-03	3.60E-02 **	4.41E-02 ***	3.05E-02	4.36E-03
OURB	3.00E-02 *	-1.84E-02	-1.09E-02	-5.12E-03	9.58E-03	1.79E-02	7.86E-03
SCITY	2.01E-02	8.01E-03	3.76E-02 ***	3.89E-02 ***	4.53E-02 ***	-4.67E-03	1.19E-02
MCITY	-4.16E-03	5.30E-02 **	4.49E-02 ***	6.52E-02 ***	7.47E-02 ***	1.44E-02	3.17E-06
SUBRB	2.33E-02	4.17E-02	1.97E-02	4.27E-02 ***	7.08E-02 ***	-3.10E-02 *	-4.11E-02 **
LCITY	6.50E-02 ***	2.94E-02	5.78E-02 ***	5.89E-02 ***	8.03E-02 ***	3.70E-02 **	-1.19E-02
LOWTEACH	-4.25E-03	1.67E-02	3.66E-02	5.95E-02 ***	6.94E-03	8.85E-03	-2.39E-02
COLTEACH	1.04E-01 ***	8.27E-02 *	9.40E-03	-1.14E-02	9.60E-02 ***	-4.57E-02	-1.12E-01 ***
WRITER	1.71E-01 ***	1.34E-01	7.48E-02	-6.89E-02	1.01E-01 **	-3.91E-02	-2.13E-01 ***
LAWYER	2.08E-01 **	5.19E-02	2.07E-02	5.02E-02	5.05E-01	-7.35E-02	-1.46E-01 **
CLERGY	1.22E-01	-4.39E-02	3.09E-02	1.46E-02	-3.08E-02	-2.23E-03	4.24E-02
CLERGYFU	1.11E-02	1.44E-03	1.67E-02	3.92E-02	1.29E-01 **	-9.53E-02	-3.03E-02
PRIEST	1.71E-02	5.82E-02	7.49E-02	1.06E-02	1.13E-01 **	1.45E-02	-1.21E-01 **
BLACCL	1.27E-01	-5.23E-03	4.92E-02	5.10E-02	1.63E-02	4.14E-02	-1.24E-02
ARMY	-3.68E-02	-1.52E-02	-7.68E-03	-8.69E-03	3.21E-02	9.42E-03	2.11E-01 ***
GOVNP	4.62E-02	6.81E-03	3.38E-02	-1.03E-02	-9.33E-03	-1.82E-02	-1.72E-01 ***
NCOLYPR	-5.82E-02 ***	-3.02E-02 *	3.33E-02 ***	2.28E-02 ***	3.86E-02 ***	1.06E-02	-3.75E-02 ***
COLYR	1.04E-02	-2.38E-02 **	-8.94E-03	3.16E-02	4.68E-03	-3.69E-02 ***	-6.61E-02 ***
AGENCYLYR	6.23E-04	3.89E-04	-4.40E-04	-3.07E-04	-4.60E-04	-3.95E-04	5.10E-04
AGCECOLYR	1.97E-04	1.29E-04	-1.78E-04	-5.39E-04	1.18E-04	-4.16E-05	6.52E-04 ***
NCVRSLOPE	-4.52E-02 ***	-1.30E-02 *	1.38E-02	9.11E-03 ***	1.82E-02 ***	-7.00E-03	-2.67E-02 ***
COLYRSLOPE	1.45E-02 ***	-1.81E-02 ***	-1.68E-02 ***	7.68E-03 ***	9.92E-03 ***	-3.87E-02 ***	-5.24E-02 ***
MALE	-1.95E-02 **	-4.59E-02 ***	-5.63E-02 ***	-6.48E-02 ***	-4.00E-02 ***	-9.40E-02 ***	4.20E-02 ***
YEAR	-2.76E-03 ***	-1.57E-02 ***	2.39E-03	1.38E-02 ***	3.53E-03 ***	-5.70E-03 ***	-4.48E-03 ***
NE	8.83E-02 *	1.64E-01 ***	5.45E-02	4.79E-02	1.12E-01 ***	4.30E-02	-8.38E-02 ***
MA	-2.38E-02	3.09E-02	3.66E-02	3.34E-02	1.04E-01 ***	3.05E-02	-3.06E-02
ENC	-9.59E-03	4.57E-02	-1.30E-02	9.63E-03	5.74E-02 ***	3.08E-02	-5.70E-04
WNC	6.53E-02 *	-7.97E-02 *	-1.23E-02	3.95E-02	7.66E-02 ***	-5.31E-02 *	2.72E-03
SA	-5.28E-02 *	-3.61E-02	-1.43E-02	6.11E-02 ***	5.01E-02 **	3.98E-03	7.41E-02 ***
ESC	5.03E-02	-8.92E-03	-1.57E-02	3.71E-02	8.21E-03	5.51E-02	1.29E-01 ***
WSC	2.55E-02	-8.20E-02 *	-4.47E-02 *	1.76E-02	4.43E-02 *	4.11E-03	1.29E-01 ***
MT	2.28E-02	5.48E-02	-5.57E-03	3.39E-02	-1.39E-02	9.35E-03	7.44E-03
16NE	-4.74E-02	-3.32E-02	1.22E-02	-3.67E-02	2.54E-02	-3.67E-02	2.55E-02
16MA	-4.67E-02	5.63E-03	-1.19E-03	-6.89E-02 ***	1.85E-03	-1.26E-02	8.37E-03

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\* Significance at 10% level    \*\* Significance at 5% level    \*\*\* Significance at 1% level

Table 1(continued) : OLS Regression of Support for Government, Political Parties and Candidate

INDEPENDENT VARIABLE	ANTICRIME	PROROAD	PROMASS	PROPARK	PROCTY(0)	PROCTY(1)	PRORACE(0)
DEFPNT	1,60E-02 **	6,81E-03	2,96E-03	-3,38E-02 ***	-1,25E-02	-2,58E-02	-2,86E-02 ***
FY	-2,26E-03	-2,27E-03	3,65E-03	-9,06E-03 ***	-2,64E-03	-8,92E-03	-6,65E-04
FYSLOPE	1,76E-02 ***	8,34E-03	4,91E-04	-2,77E-02 ***	-1,07E-02	-1,97E-02	-2,82E-02 ***
SELF	-3,29E-02 ***	-5,48E-02 ***	-2,10E-02	-2,77E-02 ***	-4,46E-02 ***	-2,80E-02	-3,12E-02 ***
PROF	-3,26E-02	3,14E-03	-1,16E-02	-2,00E-02	-9,57E-03	-1,25E-02	-5,92E-02 ***
MGM	-2,60E-02 **	4,27E-03	-4,45E-03	-2,10E-02	-5,74E-02 ***	-1,34E-02	-4,89E-02 ***
CLERK	1,88E-02 **	4,15E-03	9,51E-03	-9,75E-03	-7,60E-03	-3,97E-03	-1,66E-02
SALES	1,34E-02	3,19E-02 **	2,87E-03	2,99E-03	-1,92E-02	-1,37E-02	-9,86E-03
SERVE	3,36E-03	3,12E-02 **	6,64E-03	4,17E-03	1,95E-02	1,26E-02	3,49E-02 ***
AGR	-5,34E-02 **	8,77E-03	-3,05E-02	-5,92E-02 **	-9,68E-02 ***	-1,26E-01	2,00E-02
BLACK	4,22E-02 ***	-4,71E-02 ***	6,41E-02 ***	1,32E-01 ***	2,58E-01 ***	2,06E-01 ***	0,00E+00
UNION	3,08E-02 ***	3,61E-02 ***	1,32E-02	2,15E-02 **	4,26E-03	-2,18E-03	-2,71E-02 ***
GOVPR	-3,73E-02 ***	0,00E+00	0,00E+00	0,00E+00	2,96E-02 **	2,35E-02	-3,78E-02 ***
MAIN	7,72E-03	-3,48E-03	3,48E-03	1,97E-03	1,96E-02	2,99E-02	8,42E-03
JEW	4,53E-02	-1,10E-01	6,32E-03	6,76E-02	1,96E-01	1,98E-01	2,10E-01 ***
JSLOPE	-2,26E-02	-6,73E-02	-4,46E-02	4,89E-02	2,53E-01 ***	2,08E-01	1,91E-01 ***
CATHOLIC	2,01E-02	-5,25E-03	-3,38E-02	-1,65E-02	2,99E-02	3,77E-02	-3,65E-03
CSLOPE	-1,00E-02	-1,13E-03	-2,45E-02	5,23E-03	2,23E-02	1,26E-02	4,06E-02
NOREL	-9,23E-02 ***	-1,76E-03	2,68E-02	5,10E-02 *	1,65E-02	6,14E-02	9,54E-02 ***
OTHREL	-8,21E-02 ***	-5,25E-03	3,31E-03	6,53E-02	8,80E-02	6,24E-02	4,34E-02
ATTEND	6,32E-03	-2,27E-03	7,35E-04	-4,06E-03	-1,02E-04	1,10E-02	-1,20E-02
ATTENDSL	-1,59E-03	-3,27E-03	9,33E-05	-1,59E-03 ***	2,46E-03	-2,24E-05	7,37E-03 ***
PAIT	-7,37E-03	2,77E-03	-4,86E-03	-2,48E-05	-4,22E-04	-1,00E-02	8,00E-03
CATT	-7,56E-03	1,04E-03	2,32E-03	5,46E-03	-1,90E-03	-6,32E-03	1,11E-02
JATT	-1,71E-02	1,07E-02	-1,28E-02	-4,69E-03	1,42E-02	2,60E-03	-4,71E-03
FUNDAT	-5,39E-04	-1,66E-03	1,09E-03	-1,61E-03	1,56E-03	-1,61E-03	6,00E-03 ***
FYNCOME	-6,06E-02	4,36E-02	1,13E-01 **	-1,54E-02	-9,14E-04	-4,68E-02	4,07E-02
FMARRIED	6,59E-02	1,02E-01	-3,10E-02	-2,00E-02	-9,77E-02	-7,17E-02	8,37E-02
MARRIED	1,65E-02 **	9,80E-03	-1,36E-02	-2,35E-03	-1,79E-02	-1,05E-02	2,25E-03
CHILD	1,16E-02	2,24E-02	-2,29E-02	-4,42E-03	1,48E-02	1,85E-02 ***	-3,07E-02 ***
NCHILD	-6,52E-03	-2,16E-02 ***	9,61E-04	1,78E-02 **	-1,18E-02 *	3,91E-03	1,18E-06
STATMIG	-9,60E-04	-7,69E-03	3,71E-02 ***	-1,76E-03	2,70E-03	-1,03E-02	-6,83E-03
CONTMIG	-1,93E-02 **	-8,87E-03	6,32E-02	1,58E-02	3,65E-02 ***	2,53E-02	1,28E-02
MIGSL	-1,12E-02	-8,35E-03	5,18E-02 ***	8,07E-03	2,16E-02 **	9,65E-03	4,17E-03
CLERGYSL	4,81E-02	-1,36E-03	-1,26E-02	-5,38E-02	-3,24E-02	1,40E-02	7,75E-02
AGE	1,91E-03	2,59E-03	-1,64E-03	-1,30E-02 ***	-1,23E-02 ***	-3,53E-04	-1,42E-02 ***
AGE2	-1,21E-05	-4,96E-05 ***	-2,09E-05	3,27E-05	6,48E-05 ***	-1,73E-05	1,09E-04 ***
AGESL	9,38E-05	2,99E-03	1,05E-03 ***	-4,71E-03 ***	-3,72E-03 ***	-1,55E-03 **	-4,73E-03 ***
MEMNUM	1,54E-03	-6,24E-04	7,64E-03	1,24E-02 ***	-1,58E-03	7,82E-03	7,39E-05
LCCT	5,84E-02 ***	-4,22E-02	1,01E-01 ***	6,67E-02 ***	0,00E+00	1,17E-01 ***	8,32E-02 ***
SCCIT	3,33E-02 ***	-8,08E-02 ***	4,38E-02 ***	9,11E-03	0,00E+00	0,00E+00	1,68E-03
SSURB	1,98E-02	-7,45E-02 ***	3,87E-02 **	-1,47E-02	7,65E-02	0,00E+00	7,06E-03
LSURB	2,41E-02	-6,48E-02 ***	6,22E-02 ***	2,62E-03	1,20E-01 ***	0,00E+00	-7,13E-03
OURB	-1,73E-04	-5,34E-02 ***	1,60E-02	-5,10E-03	4,98E-02	0,00E+00	2,74E-02 ***
SCITY	3,19E-02 ***	-1,02E-02	3,37E-02	3,73E-02 ***	3,08E-02 **	-3,03E-02	5,32E-02 ***
MCITY	4,10E-02 ***	-4,41E-02 ***	3,42E-02 **	6,35E-02 ***	4,63E-02 ***	-3,87E-02	3,19E-02 **
SUBRB	9,68E-03	-4,55E-02 **	2,61E-02	3,29E-02 **	8,15E-02 ***	-2,52E-02	4,10E-02 **
LCITY	4,76E-02 ***	-2,77E-02	6,29E-02 ***	7,30E-02 ***	1,00E-01 ***	1,14E-02	4,41E-02 ***
LOWTEACH	5,50E-03	-4,06E-02 *	-3,43E-02	1,73E-02	5,89E-02	6,22E-02	7,05E-04
COLTEACH	-7,49E-02 ***	1,36E-02	-6,22E-03	2,51E-02	8,77E-02 ***	4,78E-02	9,88E-02 ***
WRITER	-2,83E-02	2,73E-02	2,97E-02	-3,90E-02	-3,19E-02	1,06E-01	1,09E-01 **
LAWYER	-5,51E-02	3,34E-02	1,15E-01 **	3,41E-03	4,77E-02	9,34E-02	7,06E-02
CLERGY	4,62E-02	3,94E-03	1,82E-03	-6,09E-02	-8,48E-03	-5,25E-03	7,38E-02
CLERGYFU	1,59E-02	-4,42E-02	-1,20E-01 *	5,97E-02	-1,99E-01 **	1,60E-01	3,06E-02
PRIEST	-2,67E-02	6,60E-02	1,30E-01 **	-1,91E-02	5,04E-02	5,40E-02	5,38E-02
BLACCL	3,99E-02	-9,01E-02 **	1,61E-02	4,46E-02	-1,20E-02	-4,66E-03	1,06E-01
ARMY	4,84E-02 *	-3,93E-02	2,93E-03	-3,43E-02	-1,68E-02	-8,85E-02	-1,50E-01 ***
GOVPRN	-4,49E-02	4,48E-02	2,10E-02	6,62E-02 *	-8,94E-03	1,00E-01	1,42E-01 ***
NCOLYPR	1,75E-02 **	-1,33E-02	-1,93E-02	-2,41E-02 **	-7,18E-03	2,89E-03	1,80E-03
COLYR	-1,51E-02 **	-1,17E-02	3,36E-02 ***	-1,90E-02 ***	-6,84E-03	4,57E-02 ***	3,34E-02 ***
AGENCOLYR	-8,91E-05	4,01E-04 *	4,29E-04	4,40E-04 **	2,21E-04	1,12E-04	-6,35E-06
AGECOLYR	4,33E-05	2,66E-04	-1,58E-04	3,69E-04 **	3,10E-04 *	-6,75E-04 **	-1,16E-04
NCOLYRSL	1,35E-02	4,53E-03	-2,24E-04	-4,55E-03	2,63E-03	7,88E-03	1,52E-03
COLYRSL	-1,32E-02 ***	1,01E-04	2,66E-02 ***	-2,61E-03	6,95E-03 **	1,57E-02 ***	2,83E-02 ***
YEAR	-5,44E-02 ***	9,68E-02 ***	8,63E-03	3,47E-02 **	-7,16E-02 **	-3,15E-02	-6,03E-02 ***
MALE	-1,44E-04	-3,91E-03	4,20E-03	-6,32E-05	8,04E-03 ***	-9,50E-03 ***	-1,25E-03
NE	2,24E-02	4,58E-02	-8,12E-02	-3,42E-02	1,99E-01	-3,66E-03	9,14E-02 ***
MA	2,10E-02	1,17E-01 ***	-9,07E-02	-1,25E-02	4,37E-02	1,95E-01	-2,73E-02
ENC	3,24E-02	5,74E-02	-9,10E-02	-4,31E-02 *	8,45E-02 ***	4,52E-02	-2,87E-02
WNC	1,96E-02	1,54E-02	-1,04E-01	-1,18E-01 ***	8,11E-02	1,90E-01 ***	1,16E-03
SA	4,63E-02 **	-3,42E-02	-1,16E-01	-4,09E-02	-2,78E-02	1,72E-03	-1,16E-01 ***
ESC	4,99E-02 *	2,60E-02	-1,47E-01 ***	-4,94E-02	-8,84E-03	-4,90E-02	-1,65E-01 ***
WSC	2,47E-02	-3,04E-02	-1,25E-01 ***	-7,26E-02 **	-1,16E-02	-1,63E-03	-1,37E-01 ***



## KENNETH GREENE / PHILLIP NELSON

MT	-5,78E-03	2,26E-02	-2,32E-02	-8,81E-02 ***	-4,81E-02	-1,49E-02	1,51E-02
16NE	-1,42E-02	3,19E-02	3,53E-02	9,23E-02 **	-7,92E-02 *	3,15E-02	-5,37E-03
16MA	-1,83E-02	1,07E-02	-2,39E-03	5,56E-02 *	-1,10E-02	-3,33E-02	-1,87E-02

\* Significance at 10% level    \*\* Significance at 5% level    \*\*\* Significance at 1% level

Table 1(continued) : OLS Regression of Support for Government, Political Parties and Candidate

DEPENDENT VARIABLE	INDEPENDENT VARIABLE	PRORACE(1)	ANTIABORT	PROREPUBL	PROCONSERV	PRESR
FY		-3,02E-02 *	-3,85E-01 ***	2,11E-01 ***	1,57E-02 ***	5,62E-02 ***
FY2		-7,72E-03	-3,53E-02	7,73E-02 ***	5,94E-03 ***	1,66E-02 ***
FYSLOPE		-2,50E-02 *	-3,62E-01 ***	1,59E-01 ***	5,95E-02 ***	4,50E-02 ***
SELF		-8,06E-02 **	-1,24E-01 ***	1,92E-01 ***	4,12E-02 *	3,04E-02 ***
PROF		-6,63E-02	-5,13E-01 ***	-1,57E-02	2,99E-02	-8,27E-02 ***
MGM		-3,30E-02	-4,67E-02	2,22E-01 ***	3,50E-02	4,52E-02 ***
CLERK		1,05E-02	-2,33E-01 ***	1,46E-01 ***	4,52E-02 **	4,14E-02 ***
SALES		1,41E-02	-1,77E-01 *	2,38E-01 ***	8,26E-02 ***	3,92E-02 ***
SERVE		-1,55E-02	1,69E-01 *	6,34E-03	-4,68E-02	1,24E-02
AGR		3,08E-02	-2,05E-01	2,07E-01 ***	-1,41E-02	6,45E-03
BLACK		0,00E+00	-7,07E-02	-1,29E+00	-3,10E-01 ***	-4,12E-01 ***
UNION		4,97E-02 ***	-1,61E-01 **	-2,33E-01 ***	-7,16E-02	-4,43E-02 ***
GOVR		-1,80E-02	9,02E-03	-1,59E-01 ***	-1,59E-01 ***	-3,96E-02 ***
MAIN		-7,26E-02	-3,17E-01 ***	-8,05E-02	-1,13E-03	-2,67E-02 **
JEW		-4,84E-01 *	-3,06E-01 **	-1,27E+00	-5,38E-01 ***	-2,93E-01 ***
JSLOPE		-1,68E-01	-1,06E+00 **	-1,37E+00	-4,82E-01 ***	-3,17E-01 ***
CATHOLIC		1,23E-02	-2,72E-01	-3,15E-01 ***	-1,21E-02	-6,29E-02 ***
CSLOPE		2,38E-02	3,50E-01	-3,84E-01 ***	-8,15E-02	-1,17E-01 ***
NOREL		-2,71E-02	-5,79E-01 ***	-8,51E-02	-3,14E-01 ***	-1,36E-01 ***
OTHREL		5,08E-02	-2,91E-01 ***	-1,47E-01 ***	-9,46E-02	-1,57E-01 ***
ATTEND		-8,97E-03	3,20E-01 ***	4,51E-04	8,34E-02	1,73E-02
ATTENDSL		-4,13E-03	5,16E-01 ***	4,14E-02 ***	4,67E-02 ***	1,12E-02 ***
PATT		8,37E-03	-1,29E-01 ***	5,91E-02 ***	2,60E-03	-3,90E-03
CATT		2,88E-03	1,56E-01 ***	-1,74E-02	-1,74E-02	-1,36E-02 **
JATT		7,93E-02 *	-1,90E-01	-2,54E-02	1,40E-02	-6,01E-03
LIBAT		-1,41E-03	-1,33E-01 ***	4,36E-03	-1,77E-02 ***	-5,90E-05
FYINCOME		5,79E-02	-1,42E+00 ***	2,98E-01 ***	-1,21E-01	3,03E-02
FMARRIED		1,10E-01	3,74E-01 ***	1,23E+00 **	2,41E-01	8,58E-02
MARRIED		4,02E-02 **	5,29E-01 ***	1,37E-02	9,59E-02 ***	1,09E-03
CHILD		-1,38E-02	-2,36E-01 **	-9,90E-03	-2,27E-02	-4,22E-03
NCHILD		-1,22E-03	3,05E-01 ***	1,56E-02	3,30E-02 ***	2,65E-03
STATMIG		-4,69E-02 *	2,28E-02	7,16E-02 **	2,90E-02	8,32E-03
CONTMIG		-1,76E-02	-7,38E-03	1,02E-01 ***	-1,04E-03 *	8,04E-03
MIGSL		-3,05E-02 *	5,90E-03	8,86E-02 ***	1,21E-02	8,16E-03
CLERGYSL		-1,67E-01	1,92E+00 ***	2,02E-03	2,33E-02 *	4,73E-03
AGE		3,12E-03	-3,63E-02 *	-8,29E-02 ***	5,96E-03	-7,16E-03 ***
AGE2		-2,93E-05	1,07E-04	5,60E-04	-9,67E-05	5,93E-05
AGESL		-3,79E-04	8,31E-06	-1,02E-02 ***	7,74E-03	-1,40E-03 ***
MEMNUM		9,42E-03	-8,80E-02 ***	-2,01E-02 **	-7,98E-03	-1,97E-03
LCBIT		2,50E-02	-6,87E-01 ***	-3,00E-01 ***	-1,95E-01 ***	-7,26E-02 ***
SCBIT		7,42E-03	-4,75E-01 ***	-1,68E-01 ***	-8,08E-02	-5,74E-02
SSURB		5,27E-02	-3,60E-01 ***	-1,88E-02	-8,55E-03	-9,42E-03
LSURB		7,97E-02 *	-4,28E-01 ***	4,57E-02	-3,51E-02	-1,72E-04
OURB		-2,19E-02	-1,01E-01	-9,45E-02 ***	-3,12E-02	-3,03E-02 ***
SCITY		5,79E-02 **	-1,37E-01 ***	-4,87E-02	-6,35E-03	-1,19E-03
MCITY		5,00E-02 *	-4,54E-01 ***	-3,81E-02	-6,33E-02	2,73E-03
SURRB		-6,82E-03	-4,95E-01 ***	5,69E-02	-7,51E-02 **	3,65E-03
LCITY		4,38E-02	-5,71E-01 ***	6,39E-03	-1,97E-02	5,27E-03
LOWTEACH		4,20E-02	2,36E-01	-4,02E-02	-5,84E-03	-4,75E-04
COLTEACH		3,59E-02	-1,87E-01	-3,00E-01 ***	-1,17E-01 ***	-6,39E-02 ***
WRITER		-4,00E-01	-6,28E-01 ***	-5,59E-02	-1,52E-01	-2,61E-02
LAWYER		-2,24E-02	-6,56E-01 ***	-2,17E-01	-1,34E-01	-1,06E-01 **
CLERGY		-1,40E-01	1,85E+00 ***	-1,50E-02	3,78E-03	6,08E-03
CLERGYFU		-2,23E-01	5,47E-01	1,42E-01	1,63E-01	-1,13E-02
PRIEST		-1,10E-01	3,68E-01 ***	-1,08E-01	-1,17E-01	-1,16E-03
BLACCL		5,70E-02	-1,21E+00 ***	-4,70E-01 ***	-1,73E-01 **	-3,63E-02
ARMY		-7,22E-02	-3,60E-01 ***	9,76E-02	1,26E-01	4,62E-02 **
GOVNP		5,13E-02	2,37E-02	-2,14E-01 **	-1,65E-01 ***	-7,63E-02 ***
COLYPR		1,37E-02	-3,36E-01 ***	-8,94E-02 **	-4,72E-02 ***	7,01E-03
COLYR		-1,67E-03	-3,27E-01 ***	-4,26E-02	-9,50E-02	-2,79E-02 ***
AGENCOLYR		-9,12E-05	1,98E-03 *	1,83E-03	-5,29E-04 *	-1,58E-05
AGECOLYR		8,89E-05	3,62E-03 ***	1,97E-03	1,28E-03	4,94E-04 ***
NCYRSLOPE		9,62E-03 *	-2,48E-01 ***	-8,14E-03	2,37E-02	6,31E-03 ***
COLYRSLOPE		2,28E-03	-1,66E-01 ***	4,48E-02	-3,80E-02	-6,02E-03 ***
MALE		-3,06E-02 ***	3,35E-01 ***	1,59E-01 ***	1,39E-01 ***	4,56E-02 ***
YEAR		-3,89E-03 ***	2,52E-02	2,29E-02	1,20E-02	-6,85E-04
NE		2,06E-01 ***	3,64E-01 ***	1,09E-01	-3,46E-02	2,02E-02
MA		1,05E-01 **	5,54E-01 ***	4,96E-02	-3,75E-02	8,40E-03
ENC		6,94E-02	1,08E+00 ***	-3,12E-02	4,89E-02	1,67E-02
WNC		1,12E-01 *	1,23E+00 ***	-8,40E-02	2,62E-02	-1,75E-02

## MORALITY AND THE POLITICAL PROCESS

SA	3,85E-02	4,66E-01	**	4,61E-02	3,65E-02	**	4,16E-02	**
ESC	3,50E-02	7,78E-01	***	-4,63E-03	1,30E-01	**	3,16E-02	
WSC	7,02E-03	6,62E-01	***	1,91E-02	9,41E-02	*	7,89E-02	***
MT	-2,91E-01	5,56E-01	***	-6,61E-02	8,08E-05		2,37E-02	
16NE	-3,32E-02	-4,09E-01		2,41E-02	-6,40E-02		-1,19E-02	
16MA	4,28E-02	-3,48E-01	*	2,60E-01	-3,10E-02		2,51E-02	

\* Significance at 10% level

\*\* Significance at 5% level

\*\*\* Significance at 1% level

### KEY TO TABLE 1

#### I. Dependent Variables

1. PROWELF: Are we spending too little (1), about the right amount (2), or too much (3) on welfare?
2. PROPOOR: Are we spending too little (1), about the right amount (2), or too much (3) on assistance to the poor
3. PROHEAL: On improving and protecting the nation's health?
4. PROED: On improving the nation's educational system?
5. PROENV: On the environment?
6. PROSOC: On Social Security?
7. PROARMS: On the military, armaments, and defense?
8. ANTICRIME: On halting crime?
9. PROROAD: On highways and bridges?
10. PROMASS: On mass transportation?
11. PROPARK: On parks and recreation?
12. PROCITY (0): On solving the problems of big cities? (for those living in cities)
13. PROCITY (1): On solving the problem of big cities? (for those not)
14. PRORACE (0): On improving the conditions of blacks? (for non blacks)
15. PRORACE (1): On improving the conditions of blacks? (for blacks)
16. ANTIABORT: Should it be possible for a pregnant women to obtain a legal abortion under 7 different
17. conditions and dependent variable runs from 7 (all no) to 14 (all yes).
18. PROREPUBL: Identifications with Republican party from strong democrat (1) to strong republican (7).
19. PROCONSERV: Political views from extremely liberal (1) through extremely conservative (8).
20. PRESR: Vote for or would have voted for Republican presidential candidate.

**II. Independent Variables**

1. FY = ln of family income relative to mean family income estimated by a Pareto distribution.
2. FY2 = the square of the above.
3. FYSLOPE = the coefficient of FY evaluated at the mean levels of variables it interacts with.
4. SELF = self employed.
5. PROF = professional or technical workers.
6. MGM = managers and administrators.
7. CLERK = clerical workers.
8. SALES = sales workers.
9. SERVE = service workers.
10. AGR = farmers and farm laborers, etc.
11. BLACK = Afro-Americans.
12. UNION = union membership by self.
13. GOVEMP = respondent employed by government.
14. MAIN = Protestant and not Baptist, Holiness Pentecostal, or other.
15. JEW = Jewish.
16. JSLOPE = the coefficient of JEW evaluated at the mean levels of the variables it interacts with.
17. CATHOLIC = Catholic.
18. CSLOPE = coefficient of CATHOLIC evaluated at mean level of variables it interacts with.
19. NOREL = no religious preference.
20. OTHREL = religious preference other than Jewish, Protestant or Catholic.
21. ATTEND = from zero (never) through 8 (several times a week) for attendance at religious services.
22. ATTENDSL = Attend slope.
23. PATT = interaction of ATTEND and MAIN.
24. CATT = interaction of ATTEND and CATHOLIC.
25. JATT = interaction of ATTEND and JEWISH.
26. FUNDAT = interaction of ATTEND and ONE minus MAIN.
27. FYINCOME = the average income of the religious denomination to which one belongs.
28. FMARRIED = the percent of one's religious denomination never been married or divorced.
29. MARRIED = married.

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30. CHILD = parent of a child at some point in life.
31. NCHILD = number of children parented.
32. STATMIG = located elsewhere in the state at age 16.
33. CONTMIG = located in a different state at age 16.
34. MIGSL = the coefficient of migratory status evaluated at mean.
35. CLERGYSL = CLERGY Slope.
36. AGE = age.
37. AGE2 = the square of age.
38. AGESL = Age slope.
39. MEMNUM = number memberships in sixteen voluntary organization types.
40. LCCIT = resides in a central city of 12 largest SMSA.
41. SCCIT = resides in a small city of next largest central SMSA.
42. SSURB = resides in a suburb of one of 12 largest SMSA.
43. LSURB = resides in a suburb of one of next 88 largest SMSA.
44. OURB = residence in countries having towns of 10,000 or more.
45. SCITY = resides in suburbs of smaller central city.
46. MCITY = resides in central city of any but the top 100 SMSA's.
47. SUBRB = resides in suburbs of central city of any but the top 100 SMSA's.
48. LCITY = resides in central city of a smaller central city.
49. LOWTEACH = employed as a teacher other than in college or university.
50. COLTEACH = employed as a college or university teacher.
51. WRITER = editors or reporters.
52. LAWYER = lawyers and judges.
53. CLERGY = clergymen.
54. CLERGYFU = clergy interacted with (1-MAIN).
55. PRIEST = clergy interacted with CATHOLIC.
56. BLACCL = clergy interacted with BLACK.
57. ARMY = membership in the armed forces.
58. GOV = employed by government.
59. NCOLYPR = number of years of formal schooling at 12 grade or below.
60. COLYR = number of years of college.
61. AGENCOLYR = interaction of age and number of years of non-college education.

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62. AGECOLYR = interaction of age and number of years of college education.
63. NCYRSLOPE = the coefficient of non-college years of education evaluated at the means of the variables it is interacted with.
64. COLYRSLOPE = the coefficient of college years of education at the means of the variables it is interacted with.
65. MALE = male.
66. YEAR = 1972 = 1.
67. - 74. Resides in one of 8 regions of US: NE, MA, ENC, WNC, SA, ESC, WSC, MT.
75. - 82. Resided in one of 8 regions at age 16.
83. SIGETHNIC = there are dummy variables for each of 38 ethnic groups specified in Nelson [1994] and this refers to the number of such that were significant at the 5% level or better.

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## 27 Economic Morality as a Competitive Asset<sup>1</sup>

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- I. Competition Among Locations
- II. Tribal Morality and Macro Society
- III. Civic Morality
- IV. The Cosmopolitan Dimension
- V. Markets and Morality in the Open Society
- VI. Attributes of Civic Morality

Though written and translated a few years ago, this essay is dedicated to Jim Buchanan on the occasion of his 80th birthday as it tries to cover some of the ground we have in common in our thinking. When forming my views I had the benefit of reading what he wrote, and when we occasionally met, I greatly benefited from stimulating discussions though my memory is not so reliable as to allow me to say specifically and in writing when and where we agreed, or merely agreed to disagree.

My point in the present essay is this: The phenomenon of globalisation includes the high mobility of investment capital and hence the competition of countries and locations for new capital and jobs. Competition forces countries and local institutions to invest in intangible as well as tangible assets. Reputation is a competitive asset not only for peaceful rivalry among individuals and institutions but also for competition among locations. People identifying themselves with their country of birth or their location of residence benefit from - and contribute to - the up and down of the rating which the place is accorded on the moral stock exchange. Local communities - like individuals and firms - are under competitive pressure to behave decently in the sense that they meet the implicit expectations for which they were re-

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1 Reprint of "Economic Morality as a Competitive Asset" in: A. HAMLIN, H. GIERSCH AND A. NORTON (Eds.): *Markets, Morals and Community*, Sydney (Centre for Independent Studies) 1996, pp. 19-42; which was an edited translation from the German original "Wirtschaftsmoral als Standortfaktor", the text of a lecture at the Max-Planck-Institute for Research into Economic Systems, in Jena, Germany.

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warded in the form of relatively cheap credits. Competition for mobile resources is then likely to lead to the emergence of a cosmopolitan system of values. Countries and locations which prove to be unreliable and do not catch up with the prevailing level of moral expectations are likely to pay a high price, e.g. in the form of a spectacular capital market crisis. Note that the following text, written in German and translated by Wolfgang Kasper, was prepared well before the Asian crisis of 1998.

### **I. Competition Among Locations**

There has been a mighty increase in locational competition at the international level during recent decades. This happened when many countries opened their markets and lifted border controls on capital flows. Investment capital is today highly mobile amongst nations. Nations are competing for the favours of investors who create jobs. There is more and more political discussion about whether a country or a region has lost its competitiveness, or has gained on the score. One is reminded of international competition in sport; only that the prizes are not medals, but jobs.

In locational competition it is those who own the mobile resources who put a value on the immobile assets. Ultimate locational decisions are made by people looking for high returns on capital assets or wanting to find the best place to live and work. The owners of mobile resources are faced with the competition amongst localities, land owners and people unwilling or unable to move around. As a consequence, the owners of land and the immobile workers will benefit from a region having a reputation for attractiveness.

The choice of location involves numerous considerations. In the final analysis, firms search for a location where the enterprise, and those who will have leadership positions in it, can expect the highest returns. But the expectation of maximum profit is only a part of the answer in the search for the best location. Apart from cost advantages and market access, non-material costs and benefits count in the choice of location. These are probably playing a growing role in the competition amongst locations for business and jobs. We shall call these factors the 'soft location factors' to distinguish them from the 'hard factors' that are covered by the economic calculus of business costs and revenues.



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When thinking of soft location factors one has nowadays to consider the natural environment. People do not want to stay or go where they dislike the environment, unless they receive additional pay to make up for environmental shortcomings. As people compare locations, they include the environment indirectly in their economic calculus. The natural environment matters to economic decisions whenever mobile people, who have the last say in the decision process, give it an important role.

The location factor, 'culture', plays a similar role. A good offering of theatre, plays and concerts creates the image of a cultured city, as do educational institutions of good repute. City councils are therefore well advised to help support school education, artists, and universities, and to maintain museums and public memorials. There is a return in terms of attractiveness - though of course a limited one. Thus, locational competition promotes not only the economy, but also culture and the arts. Would we have the chance to admire Europe's medieval cathedrals, had there not been many centuries of intense locational competition within the church? What was at stake here was of course not profit, but reputation.

International competition occurs not only between government administrations, but also between national labour markets. Competitiveness requires not just workers with skills and flexible labour markets, but also a good work culture: a strong work ethic, a willingness to perform, reliable work practices, cooperative union behaviour, and positive attitudes towards technical progress. These competitive attributes of course change over time. Once it used to be said, for example, that Germans were working too much, were too dedicated and perfectionist, and that they saved too much. Nowadays, critical voices abroad have less reason to be envious; they have come to a different verdict on the work culture of the location Germany.

Moral judgements about economically relevant facts have economic consequences and should therefore count among a society's assets and liabilities in a broad sense. They form part of the reputation that is integral to the name of a location, just as it is to a person, firm or organisation. Concepts like prestige, goodwill, and renown belong to the same category. One might also speak of 'intangible capital'. Like physical capital, it is subject to valuation. Somewhere I picked up the phrase 'image market'. It seems an apt term, carrying the right connotations but vague enough to encompass all those evaluation processes with moral content.

But image markets differ from product markets, in that there is no-one who demands an image as such, who offers a payment and therefore puts in a

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stake of his own. This increase the volatility of image markets and facilitates glorification, as well as vilification. Those whose image is at stake face verdicts that may affect their very existence to a much larger extent than is the case in other markets in which goods are traded. Moreover, product markets give rise to cooperative partnerships and commercial relations that are of durable value to suppliers and buyers, especially when they make use of the division of labour and economise on information and transaction costs. Finally, product markets are positive-sum markets where both sides of the exchange can realise their aim of gaining utility and wealth, in contrast to zero-sum markets, such as the image market, where the 'suppliers' compete amongst themselves, often producing mutual-admiration cliques and, at the same time, tendencies to denigrate outsiders.

Locational competition extends both to the positive-sum competition for wealth-creating mobile resources and to the zero-sum competition for reputation and the kind of prestige that flatters the patriotism and pride of the resident citizens. Consequently, we have to recognise the positive-sum morality (or mentality) of the traders and investors who are after wealth, and the zero-sum morality (or mentality) that revolves around pride and honour. For example, Germans before the First World War used to deprecate the English in the international competition of nations for harbouring a trader mentality. The Germans saw themselves as superior in that they strove for recognition in the world, not just mere lucre. Much has of course changed in Germany as elsewhere. Yet, much of what is now going on in Europe and elsewhere in the world cannot be fully understood if one disregards the competition for prestige. Just think of the international rivalry for world exhibitions and the Olympic Games.

It is likely that locational competition, once it was allowed to develop at the end of the Middle Ages in Europe, became the midwife of what we are today calling the market economy, the world economy, capitalism, Western civilisation, and the open society. We should note the following remarks which Max Weber made in his *General Economic History* that was published posthumously in 1923, and translated into English in 1927. He points out that the cities of medieval Western Europe enjoyed many freedoms which Russian cities did not, and that the West European cities lost these freedoms subsequently, just as the cities of Antiquity had few freedoms under Roman rule. Weber goes on:

... in contrast with antiquity, the (the West European cities of the Renaissance) came under the power of competing national

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states in a condition of perpetual struggle for power in peace and war ... This competitive struggle created the largest opportunities for modern Western capitalism. The separate states had to compete for mobile capital, which dictated to them the conditions under which it would assist them to power. Out of this alliance of the state with capital, dictated by necessity, arose the national citizen, the bourgeoisie in the modern sense of the word (Weber 1927/1981, 337).<sup>2</sup>

The rise of Western civilisation has without doubt been facilitated by a certain type of morality: the civic morality of the bourgeoisie, the civil society of free citizens. This morality constitutes, nowadays and in the future, a positive competitive asset in locational competition. It consists of the ethics of property which respects the property rights of others; the ethics of contracts which facilitate the exchange of goods and services, the division of labour, and the advancing of credit; the ethics of individuality which demands freedom from coercion and makes self-responsibility a duty; and a sense of community spirit which brings self-interest into harmony with the shared values and public demands of the location, thus contributing to the peaceful coexistence of individuals.

## II. Tribal Morality and Macro Society

Let me clarify civic morality by contrasting it with two other moralities: first, a tribal morality of the small group based on instinct, and second, a

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2 Following in Max Weber's footsteps, historians of the long term, such as JONES (1981/87) and ROSENBERG AND BIRDZELL (1986) have shown that the miracle of Western civilisation is owed to the locational competition amongst the small European states, and why this came about. Also see WEEDE (1990; 1995). The hypotheses of FINDLAY (1992) are also worth noting. He shows that small communities such as Venice, Geneva, Portugal and Holland earned their revenues from long-distance trade, not from taxing the land. He also showed that inter-state rivalry in commerce promoted the journeys of discovery and, through defence technology, the industrial revolution. Inward-looking states that covered large areas had no choice but to imitate the smaller, more open maritime nations.

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collectivist morality that aims to transfer the norms of the small group, the morality of the tribe, to modern mass society.

A plausible hypothesis says that tribal morality has genetic roots. For tens of thousands of years and hundreds of generations, humankind survived in small gangs or hordes, in kinship groups and tribes - seen from today's angle in dire material penury and often at the fringe of mere survival. Those who gathered or obtained much less food than the average could not survive.

Small-group morality is instinctual, community-oriented, communistic. The individual is understood above all as a member of a closed whole that guarantees better chances of survival than an equally sized group of individuals who each separately pursue their own aims. The communal morality of the small tribal group has been cultivated quite naturally within the family. There, it is supported mainly by the genetic altruism of parental love and in the reciprocal altruism of the marital relationship.<sup>3</sup> Beyond this, small-group morality comes to bear within neighbourhood communities, amongst friends, in cooperatives and clubs.

In Germany much of the instinctual morality of the tribe was taken up and abused by National Socialism in an esoteric-romantic variant to exploit the readiness of people to submit. 'You are nothing, your people is all', 'The banner is worth more than death' - these were typical slogans by which the propaganda of the 'Thousand Year Reich' tried to transfer tribal morality to macro society. Socialism was presented in the guise of a domineering nationalism. This appealed, above all, to the natural instincts of the young. A similar effect was obtained later in the USA when John F. Kennedy said: 'Don't ask what your country can do for you. Ask what you can do for your country!'. The 'country' thus became the symbol for 'us', some sort of community, but in this case fortunately without the taint of nationalist superiority and envy. Later, politicians did not hesitate to appeal to the 'moral equivalent of war' to solve a political task. The glorification of war and a leadership cult could of course also be observed in the Soviet system, in Cuba, China and North Korea. We shall later return to the question of totalitarian coercion.

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3 The family offers tribal morality a firm place even in the free, open society. The moral principles of the macro society come to bear in competition between families, including loose partnerships. In this way, the social ethics of the family is being controlled today by the ethics of the open society. Young people and married couples who feel overly constrained by the ethics of the family will emancipate themselves. The latent threat of leaving the family makes it more open, but leads to a decay of traditional values or, to use a neutral term, to a transformation of social values.

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In the socialist reality of recent decades - as before under Stalinism - we again discover the collectivist attempt to transfer the tribal morality to macro society. But, just as the communistic experiments of religious zealots in earlier ages were condemned to failure, so were and are the great social experiments of the recent past and the present bound to fail. This is so because ultimately any subordination of self-interest under the interest of the large collective requires coercion. One simply cannot rely on voluntary subordination. Lenin was quite frank when he said: 'Control is better'. This is the control by secret agents and informers, by police and bureaucrats. Mental coercion is then unavoidable. Instead of utilising the knowledge which is decentralised in millions of human minds and which grows by invention, if the need arises, or by mere curiosity, socialism has to rely on the all-knowing central committee. The 'pretence of knowledge', as Hayek (1988) correctly foresaw, was the real cause for the failure of the socialist experiment this century. There is an increasing demand for additional knowledge in the global competition of economic systems and locations. To ignore this is fatal.

Knowledge is especially important nowadays. We therefore have to assign a high moral rank to the institutions which create, multiply and help apply knowledge or help to economise on required knowledge. The institutions that we have to think of in this context are the liberty of the individual who wants to discover and invent; the principles of science which apply standards and rules to separate worthwhile from irrelevant ideas; and the competition in the market for ideas which spontaneously generates a global, flexible division of labour amongst human minds.

The division of labour which really creates knowledge has to be horizontal, not hierarchic, so that individuals can exhaust their creative potential. Inventive productivity is enhanced by voluntary cooperation in a team, often held together by the competition with other teams. As soon as cooperation is imposed from above, activities are centrally coordinated and bureaucratically administered, and one gets waste and obstruction. Above all, the information flow from the bottom to the top dries up. This applies to hierarchical structures, whether they be in government, business or any other type of organisation.

One therefore has to wonder why the reduction of communications costs, which we now observe, is not always thought to favour the horizontal division of labour but has sometimes been invoked to justify business concentration. Whether people who construct big business concerns will actually un-

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cover the synergies that they are searching for remains to be seen; one has to have great doubts.

Even greater reservations seem justified against the tendency towards a centralist integration in politics. This can for example be observed with the 'deepening' of the European Union. Just at the time when the megastructure in eastern Europe collapsed, West Europeans busy themselves with fashioning a super-state. Fortunately, one special exemption has been obtained - by the British Eurosceptics on social policy. This will allow us to gain experimental insights into the welfare and labour market policies of the European Community. After all, the discovery procedure of competition works when at least one participant is allowed the freedom to do something different from the others - while the others are left to pursue their follies.

If we return to the narrower confines of economic life, we can perceive competition as a moral institution of a special kind: It translates the self-interest of one side of the market, however one may evaluate this on moral grounds, into a performance that helps the other side of the market. The customer is king when suppliers compete. And when the demand side competes, suppliers are able to protect their independence and their freedom to decide. Without the active pursuit of profit, there would only be night-cap competition, and, without the discipline of competition, the greed of suppliers would lead to the exploitation of consumers by powerful monopolists. Thus, we, the consumers, owe our good provisions, as Adam Smith said, not to the charity of the baker or butcher, but to their self-interest. Competition converts second-best motives of second-best human beings into decent performance. The same holds true of governments. They only become the servants of citizens when they compete with other governments for mobile resources. This points to the moral quality of locational competition.

Conversely, substantive perils exist when business concentrates and government centralises. People are deprived of alternatives and restricted in their freedom of choice; and as time goes on the mentality and morality of the subservient subject are dictated and cultivated. Bootlickers then make headway; civil courage becomes a scarce moral asset. Those at the top of large business concerns then get less and less information about what their customers want. Those at the top of centralised administrations have no clue what citizens are really concerned about. And peevish uninterest in politics becomes a dumb form of protest.

From the viewpoint of tribal morality, competitive behaviour appears damnable and depraved. Critics miss warm-hearted comradeship and human

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sharing. instead of a comfortable order under a distributing authority, they perceive a fight of all against all, 'Elbow society' is their term to revile competition, or they speak of the 'law of the jungle'. Those in the competitive game who render services to others are depicted merely as high-income earners who deserve no better than to be handed over to the Tax State for fleecing! Populists demand that governments should produce social justice, not simply establish the rule of law. Equality before the law and court rulings without regard to the person are not considered to be fair enough. Instead, government is urged to bring about the equality of outcomes by cutting back top incomes and guaranteeing everyone a sufficiently high minimal income: To everyone according to their need.

Real-life experience, however, has shown (for example in Sweden) that a government's capacity is overtaxed by the promises of the welfare state. Assistance, which is not conditioned on self-help and own effort, is also becoming morally dubious. It generates dependence on assistance and it gives rise to moral hazard and a claims mentality. People simply adjust to the conditions they are confronted with, just as they react in the market when they buy more of a product once a greater supply has brought down its price.

By contrast, moral behaviour is fostered in well-functioning small groups, including the family, which monitors adherence to norms and taboos which have proven their worth as rules of conduct. Such groups combine - so to speak - material assistance with an encouraging pat on the shoulder. They cultivate habits of gratitude among recipients of assistance, and provide other opportunities to earn gratitude or recognition.

The macro society with its welfare state, on the other hand, has to impose strict controls so that its redistribution system is not exploited. Once solidarity is turned into a legal claim, there is need for coercion. Therefore, the price of more equality of outcomes in the modern mass society is the impairment not only of the family as a self-reliant support organisation, but also of individual liberty. The extreme case was elicited by German poet Friedrich Hölderlin when he wrote: 'What has always made the state a hell on earth has been precisely that man has tried to make it his heaven' (quoted after Hayek 1944/1972, 24).

Those who have lived under a totalitarian regime need no further explanation or evidence to accept the conclusion that the morality of the small group cannot be extended to apply to the anonymous mass society for a long time without continuous indoctrination and severe restrictions on individual liberty. Some countries like Cuba and North Korea are still in such a deplorable

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situation. others are on the way to a more open society. The driving force is the decline of communication costs, which gives rise to a growing competition among systems, locations, ideas and knowledge. This competition will limit the importance of tribal ethics to the small group where it has its comparative advantage.

### III. Civic Morality

Civic ethics, by contrast, is an ethics of individual responsibility; it is the morality of the open society. It promises liberty, and in exchange it demands that individuals are prepared to bear responsibility for their own actions. It implies and recommends that individuals are educated in self-discipline. Responsibility for one's own affairs becomes a duty.<sup>4</sup> Those who do not act responsibly fall quickly outside the morals of the open society. Liberty is, in the first instance, the freedom to gain knowledge from experience, to learn from mistakes and to avoid mistakes by participating in an exchange of experiences.

The civic mentality endorses a progressive ethics which is not constructed according to a design but is the outcome of an evolutionary process. In a progressive order, new questions and challenges are coming up continually. One or the other participant in the debate may feel it within him- or herself to design and suggest new ethical answers. This gives innovative impetuses to moral discourse in ways similar to the stimulation of market competition by new products or - in the market of ideas - by new thoughts and concepts. To use a metaphor: one might say that moral discourse meanders through unknown terrain, like a river through the moral landscape. Many a solution

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4 If you want no more than a minimum of coercion from above, you have to exercise and demand self-discipline as a *quid pro quo* for liberty. Self-discipline thus becomes a pedagogical task and part of the education for liberty. Free people must reign themselves in to stay within the rules of civic ethics, so that government does not have to act as a guardian and may instead concentrate on matters that can only be solved by collective action, such as the protection of life and property. The limits of liberty - for example in the area of the trade in human organs, dangerous weapons and environmentally damaging goods - are contentious and will probably remain so for a long time yet on the agenda for moral discourse. There are probably no alternatives to exporting the limits of liberty by conducting limited and controlled experiments.



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which this discourse turns up will fail to prove its value. It will be jettisoned and forgotten. But much will become part of the moral tradition that is worth conserving because it has proven its usefulness.<sup>5</sup>

The moral evolution of an open society does not proceed according to the principles of Darwinian theory. Our instincts may be inherited and that may make us susceptible to the temptations of collectivism, especially at a young age. But we owe the behavioural rules of Western civilisation - as Hayek showed - to the passing on of acquired knowledge along the lines of Lamarck's evolutionary theory. Over time, civilisations that are more efficient tend to expand. They gain more adherents, because they fit prevailing conditions better. Other civilisations recede because people turn away as they cannot expect sufficient life opportunities from them. Just think of the collapse of 'real socialism' or of the economic decline of Africa in the maelstrom of ethnic conflict.

The ethics of Western civilisation emerged as an economic morality that was assisted by the locational competition of cities and states (as the quote from Max Weber indicated), though its roots read back further. It is a morality of efficiency, tailored to the anonymous division of labour over great distances. This division of labour is based on exchange, specifically purchases and sales. It is predicated upon individual property rights. In this context, communal property does not count as it cannot be efficiently traded. What I do not own exclusively, I cannot offer someone else for exclusive use. And what I cannot use exclusively, does not have full value for others - or for

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5 Those who believe, like myself, that civic morality flows from cultural selection processes will have to entrust the further evolution of morality to experiments and experiences, trial and error, venturing and correcting. Thus, one might for example ask whether thefts by drug addicts would decline if soft drugs were as freely available as is the case with nicotine and alcohol. How long would it take till drug taking falls, as cigarette consumption now does? Are prohibitions more effective than bitter experience, belated in the twenties encouraging or rather discouraging? Might drug-driven criminality be reduced without major drawbacks by treating addicts as sick people in need of permanent medication? Such questions cannot be answered solely from behind a desk, for they depend on human behaviour under differing circumstances. This is why the competition of alternative locations, which we can visualise as a process of experimentation to discover, is so fundamental and promising for the evolution of our civilisation. In contrast to centralism, decentralisation is a system capable of teaching us solutions, including to moral problems. The competitive process itself is a learning process.

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me. Moreover, what belongs to many will only rarely be conserved and cultivated, at least not spontaneously.

The inviolability of property is a fundamental legal principle which is morally supported by the commandment: 'Thou shalt not steal'. Violence against property, as the 1968 generation advocated, has similarly damaging consequences as violence against persons. Both narrow the scope for the division of labour and for trade. Both forms of violence raise the costs of security, irrespective of whether these costs come about in the form of taxes or insurance premiums. Locations with high criminality against property tend to lose their attractiveness for investment and job creation. The bill is paid by the land owners, immobile labour, and governments which face a shrinking revenue base.

Similarly important for the division of labour and trade is adherence to the principles of trust and credibility; they too are cost-saving. But trust and faithfulness do not mean in this context blind faith of the sort required to save on the costs of control in vertical hierarchies; rather they refer to that sort of dependability in interpreting and fulfilling voluntary contracts which encourages future reliance and trust and which allows material gains from further specialisation. This principle gives rise to the secondary virtues which are the virtues of the honest trader and artisan: precision, punctuality, warranty, compensation for damage, high reliability in paying one's bills. People reap personal gain in cultivating these virtues because honouring these maxims creates recognition in the image market, and hence creditworthiness so that they do not have to mortgage assets or pay a high risk premium. A man's honesty becomes his good reputation only with the passage of time, after the market has tested whether he is creditworthy.

We can contrast the good standing of the honourable merchant with the distrust that bourgeois society reserves for ambulant salesmen, those migrant birds hunting after the fast buck. One can get a good feeling for the locational advantage of a community with a high civic morality if one thinks of current conditions in the former communist countries of eastern Europe. Their shortfall of traditional economic ethics is now an obstacle to the development process; things will probably improve only gradually with generational change and intensive learning processes in economic ethics (Voigt 1993).

Where one can have trust in the safety of life and property and the ready fulfilment of contractual obligations, one can expect gains from the division of labour. Insurance premiums are low; police protection need not be elaborate, and the courts have little business. In such a society, there are not only

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low security and transaction costs, but also low information costs: people do not lie. Whereas it is necessary to dissimulate the truth behind courtesies and formalities in hierarchical systems, abuse, lies and fibs soon have negative feedback and incur penalties in the open, transparent society. The truth comes out sooner than one may expect. Part of the ethics of the open society is also a certain tolerance for errors. One is simply told more if one does not immediately show misgivings; people then have less reason to come to the fearful conclusion that 'silence is golden'.

The civic virtues describe to a large extent the ethics of the market place. They inspire a type of behaviour which is worth cultivating because high costs arise if people are unreliable - in short, dishonest and without honour. Let us underline that the honour of the merchant differs fundamentally from the honour of the vassal who subjects himself to blind obedience. Since markets are based on legal property rights, the honour of the merchant demands respect for the law and preparedness to compensate for damages and torts. Civil law only steps in where civic virtues and good manners do not suffice.

As noted above, creditworthiness cannot be built up quickly. For good reasons, people do not trust those whom they do not yet know. Long-time residents often suspect strangers or mobile entrepreneurs to be speculators, after the fast buck and with no lasting commitment to productive effort. However, this suspicion is based at least partly on a misunderstanding. For to speculate means to think about the future and to derive valuations for the present from future scenarios. Of necessity there is a risk in each future-oriented engagement. However, in reality, everyone who owns property incurs a risk for the future, even if he or she only holds on to the assets or fails to sell them out of inertia. Those who say that they do not speculate either refuse to take future eventualities into account, or believe simple-mindedly that everything will always remain as it is. This may have held true in the peasant culture of yesteryear, also for the rigidified craft economy of the guilds and corporations of Middle Age Europe. But nowadays we are faced with a continuing change of structures and conditions that is driven by world market forces. Those who are not on the alert and fail to adjust by anticipating change run the risk of being left behind, to be run over and to become dependent on the help of others. After all, one cannot only make mistakes by doing something, but also by failing to act.

Another critique of speculation is aimed not so much at the seemingly effortless acquisition of wealth as at the fact that money is involved. Money, though not considered as dirty per se, marks the borderline between the tribal

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morality and the civic ethics of the open society. Those who have paid their debts are free to leave. They are, so to say, free of the duties of allegiance that bind them to the family. Those who have acquitted themselves are free to quit. They are seen a little bit as deserters, outsiders, anonymous nobodies. Thus it is the money payment that symbolises the loss of the tie to the small tribal group. Those who offer something for money may wish to be seen as strangers and can be treated as outsiders. They are on the way to the open society, free of tribal ties. And that may cast a dubious light on them. In this context, we must appreciate that openness and the anonymity of the market are placing constraints and disciplines on tribal morality. But these constraints are, of course, discomfiting and therefore not liked without reservation.

Speculation also means that one does not pursue a cause, or does not own an object, for its own intrinsic value, but that one invests because it is valued highly by others and therefore has an exchange value. The speculator consciously acts according to market forces, even when he exploits the whims of the market. Seen from the viewpoint of those imbued with tribal ethics, the speculator thus acts without respect for tradition and hence without honour.

Being oriented towards the future and discounting the past may be equally offensive. It used to be said in my youth that 'traders don't give you anything for bygones', or as the English say 'let bygones be bygones'. The cost that matters is not past effort which was duly recorded in the account books when it was expended. Rather, the cost is the future benefit forgone that we would have obtained otherwise. Curiosity about the future becomes a virtue for those who act in the market place and who act swiftly.

The market economy thrives on information. Sheer muscle power does not matter all that much, but an alert mind does. People who hear the proverbial grass grow succeed. This points the way to how the capitalist ethic fits into the modern information society and never-ending structural change: we are urged to hurry along with the times, to put curiosity before greed and to be on the alert. Such characteristics are not, as yet, widely seen as virtues. But more and more people know what characterises modern competition: time is money. It is amazing with what speed huge, complex transactions are made in share and foreign-exchange markets, if we compare this with cumbersome real-estate deals. Here one telephone call, there time-consuming contracting through solicitors and entry in a land registry! One can observe from the lifestyle of the yuppies that markets have a great influence over the mentality of the participants in these markets, whether one approves or not.

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When we are speaking of the lifestyle, we again have to think of locational factors. Wall Street is not Harvard, the London financial district is not Oxford. Of course, like and like associate with each other because similar customs, conventions and moral concepts save on communications and transaction costs. Many an idea will spread more easily among people with similar cultural backgrounds.

Human behaviour is made predictable by good manners. They dominate the middle ground of social intercourse between the tribal entity and the cosmopolitan, open society. Good manners matter in the spatial framework of local communities, regions and linguistic and cultural communities. Their content relates to what is 'proper', what earns respect and approval, what conforms to the usual expectations. Good manners facilitate human interaction in ways similar to a shared language, but they also constitute a sign of identification - if we compare differences in space - and hence constitute a locational factor. What is considered good manners has been passed down in customs; they are cultivated like a piece of land. Emotionally, they are like a piece of the home turf. Yet, conventions and good manners make economic sense only if they are of more use to those involved than what they cost to uphold or the damage they do.

Amongst friends we promise each other mutual support - a kind of reciprocity on a multilateral basis, a fraternity of cooperative help to help ourselves. This serves as a kind of private insurance on the basis of loose reciprocity, which economises on insurance costs. But fraternity may also turn into a cartel which disadvantages third parties, a conspiracy to eliminate competition or at least to make it 'fairer', or even a compact to gain a monopoly. It is possible that shared norms of behaviour serve to economise on transaction costs, to avoid certain taxes or to turn cumbersome decisions into easy routines. Thus, we pay waiters a tip of a certain percentage because everyone does it; one goes to the polls although it is of no relevance to oneself; one becomes politically engaged (or opts out) because that is prescribed by shared conventions or because one has turned one's civic duties into something like part of the family tradition. There are many examples of people engaging in a good cause although this only serves the common good of those with whom they live. Much of this may appear irrational and hard to explain. Not a few will suspect that there is such a thing as a collective rationality which ensures that selfless action pays that good manners are reciprocated and engagement for the common good earns a return. This sphere of manners and conventions, which lies between tribal morality and the ethics of

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the global society, is highly relevant to civilisation. We should not underrate its importance.

To be sure, economic man has to be self-interested to remain the race, but he does not pursue the narrow-minded, but the wider self-interest, taking the non-economic effects of his actions, or inactions, into account and by looking at externalities which may boomerang back through the market. Thus, one's reputation counts in similar ways as one's tangible assets, as we saw. Most people who want to conclude their lives successfully in both respects - earning wealth and a good reputation - will tend to become sponsors of some good cause.

The difference between self-interest and good causes can be illuminated by the concept of 'non-tuism' which the English economist P.H. Wicksteed put forward. Wicksteed wrote: 'What makes ... an economic transaction is that I am not considering your desires except as a means by which I may gratify those of someone else - not necessarily myself. The economic relation does not exclude from my mind everyone but me, it potentially includes everyone but you' (Wicksteed 1933, 174). You may dispose of your private income or wealth as altruistically as you have to for your emotional peace - now or when you pass on your inheritance. However, in business there are no moral grounds for making altruistic concessions to contract partners. Only when business considerations come to bear fully will prices reflect relative scarcities without distortions, so that the prices can serve to overcome those scarcities. Coffee planters, for instance, are not helped by offering them artificially high prices out of friendship or compassion. Higher prices would only induce more suppliers to offer more output. How much excess production and waste is generated by such concessions can be seen by looking at Europe's common agricultural policy. This is why assistance should always be given directly and outside the market, so that market prices do not get polluted.

Non-tuism creates the resources to be altruistic. The great English economic theoretician Dennis Robertson once asked the question what it is that the economist economises by teaching and applying the economic principle (Robertson 1961). His response was: love, love in the form of charity. Charity is in such short supply and so valuable in private life that one should not waste it on economic relations where it only does damage. Indeed, the sharper the calculating pencil which we apply in business, the more will be left for what we can give to the family, the church, the Salvation Army, the Third World, more generally what satisfies altruism. There is much scope for expressions of philanthropy and community spirit, also in the form of volun-

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tary transfers - which replace government transfers - to those for whom we feel sympathy.

The community spirit in a given location or region will become an increasingly important location factor. Locational competition will slim down the size of governments, including the welfare state with its system of redistribution. Many now seem to fear that this will lead to a dismantling of social security, doing damage to social cohesion. To be sure, social peace and harmony are assets in inter-locational competition. But the more intensely locations are competing for mobile capital, and for the jobs it creates, the less resonance there will be in society for outdated calls to class struggle. As within firms, competitive pressures from without enforce cooperation within. And when people can hope for economic growth, they are less likely to be envious.

### IV. The Cosmopolitan Dimension

Civic morality has its protective walls. Visitors and immigrants have difficulties in joining the establishment, the circle of established insiders, the local clubs and associations whose doors are more widely open to the sons and daughters of old-established families. Admittedly, the city is naturally more open than the village, the metropolis is more liberal than the provincial town. Distrust of strangers need not always go as far as xenophobia, but there is a general expectation that immigrants will not so easily be accepted as part of the home crowd if they act differently, and especially if they are successful.

All social systems have an inherent tendency to rigidify, not to change with the times and to close themselves off. The old does not always readily give way to the new as internal structures resist the pressures, impacts and changes that come from outside. We call this protectionism, an artificial closure of systems of thinking and acting, of morality and mentality. Xenophobia is the worst, local patriotism a harmless, manifestation of this. Protectionism seems to be supported by genetically inherited instincts which suggests to us that the exclusivist tribal mentality is only natural. We feel a certain inner warmth when we are not dealing with anonymous market forces, but with human beings whom we know and who share our joys, fears and pains. There seems to be a difference between emotional values which we

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share with our friends and which are reliably stable, and cold prices which change with scarcity and inform us continuously of events in the anonymous outside world, mercilessly forcing us to adjust. One might say that economists are cynics who - according to Oscar Wilde - know the price of everything and the value of nothing.

The fundamental principle of cosmopolitan morality is non-discrimination: treat those who are more distant from you no worse than your friends and close neighbours, the coloured person with no less respect than the white man, those of a different creed no different from your coreligionists or those who share your philosophy. It focuses on the question of the price to be offered and demanded, not on the person's values, philosophies or religion. The principle of non-discrimination can be universalised along the lines of Kant's Categorical Imperative: It can serve as a global law.

The cosmopolitan morality spread in its philosophical guise from Scotland and England to become the ethics of Western civilisation across Europe and North America. It is the individualist ethics of the bourgeoisie, of capitalism and the merchants. It stands in contrast to nationalism and socialism which derive from the ethics of the small tribe. Instead of acclaiming the state and national heroes, it serves trade and daily life, markets and money, in short: commercial affairs. This ethics is drawing more and more nations under its influence - in Central and Eastern Europe since the fall of the Wall, in the small Asian Tiger countries who follow in the wake of Japan's ascendancy; in China and in future possibly in India, and again and with partial success in Latin America. This morality now has gained global currency and will be imitated for the simple reason that it has been successful elsewhere. Its very success has great practical power to convince, more so than the critique of intellectuals or moral preachers, new sects and movements who decry the adoption of the cosmopolitan morality as a decay of the value system. It is true that capitalism 'created' the proletariat in its early history; but that happened when the paupers who otherwise would not have survived into adulthood were given the chance to survive by working for their daily bread in the factories. In our age, too, the market economy is laying bare quite a few cases of the misery of marginalised groups. In general, however, it enhances life opportunities because it allows a great diversity of talents to become productive in the global division of labour. As a consequence, a big world population can enjoy so much more affluence than would be possible if many small tribal communities existed in autarchic isolation alongside each other.



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Scarcity prices and their changes are in a certain respect the specific expressions of a cosmopolitan morality. They tell you to adjust because the global division of labour demands it. The cosmopolitan morality that tells a community to obey market signals is a competitive asset in inter-locational rivalry. After all, some countries grant themselves exemptions from the cosmopolitan imperative, from the principle of free trade, non-discrimination and most-favoured nation treatment. In the long run, protectionist countries of course pay a price for their infringement of the free-trade rule; they pay with losses in economic welfare. This is why markets are being liberalised almost everywhere. It is thanks to the surge of cosmopolitan morality, of free trade and non-discrimination, that a greatly increased population has been fed in recent history and has at the same time become more wealthy.

The principle of non-discrimination comes automatically to bear when markets are free and open, when prices are equilibrium prices and when market participants maximise utility and profits. If markets are continually cleared by price competition, there are no queues, there is no opportunity to ration things arbitrarily, to discriminate without cost. Conversely, an intervention like minimum wage legislation, which creates unemployment, gives employers the opportunity to give preference to certain employees without incurring a cost penalty. It is of course possible that people have some bias, for more or less valid reasons, and wish to follow it, but then let's make sure that they incur a cost penalty. Public opinion often prefers the imposition of a non-pecuniary penalty for discrimination: pointing the finger and castigation in public. Admittedly, markets with free prices may not be as just as we would like them to be, but they guarantee more anonymity and random selection, and hence more equality of opportunity.

Many of course dislike such a blind, anonymous mechanism. In particular, they reject it in the political market where votes are bought and sold and where some voters demand preferments, and politicians are inclined to supply them. Such political horse trading may not be completely avoidable. But when so many citizens suffer from disillusionment with political life as now seems to be the case in many countries, there is too much power in the hands of government and the politicians, relative to their morality and competency. If support for the political process in the West with its long civic tradition is so poor, how is it to work out in Eastern Europe where governments have collapsed under pressures to reform and the civic ethics is not coming to the fore? Instead, Mafia organisations with no respect for the rule of law fill the gap! Can we in such circumstances advise investors, who have to take on

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many risks anyway, to try their luck in environments where political ethics and power structures offer so much scope for discrimination and intervention? The resulting locational disadvantages are borne, as we saw, by the immobile workers in those countries. If things get bad, the most courageous may migrate to look for their economic fortunes in a better moral environment. Those left behind suffer the more.

In many of the developed industrial countries, industry, governments and local authorities are now facing the pressures of structural change which threatens jobs, even entire industry locations. Should governments then intervene to protect people from change? Seen from the standpoint of tribal ethics the answer seems an unreserved 'yes'. After all, those affected draw attention to their plight by demonstrations in front of TV camera teams that invariably just happen to have been notified. What politician would dare to reject the demands for help from groups of people who are under fire, by pointing to the costs of assistance or protection which have to be borne by the majority of fellow citizens who remain anonymous? They would soon be typecast as cynics and as cold-hearted economic rationalists.

From the standpoint of the open society, the perspective is different. Here, structural risks present themselves as the mirror picture of growth opportunities. Many a structural weakness which befalls advanced countries can fortunately be predicted as a danger. One only has to analyse the structural dynamics of the new industrial countries. Thus, the crisis of the European steel industry could be predicted as long as two decades ago. Many enterprises indeed adjusted in an anticipatory manner, changed their product mix in response to the changed location conditions and modernised their production methods.

Other firms, who chose not to adjust, now lay siege to the subsidy state. Such management failures no doubt relate also to the readiness or otherwise of governments to yield to demands for assistance, which may, if necessary, be extorted by massive pressure. Those who promise help, provoke negligence, the need for help and moral hazard. If this attitude prevails, then the morality of the open society decays. The location loses its attractiveness for the very resources that can drive economic growth forward. It becomes less attractive for people who are sure that they will be among the high income earners and taxpayers, rather than among the needy subsidy-hunters. Protectionism thus inevitably turns into a negative location factor and into a competitive liability.

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Who is paying the price for protective assistance which government is granting those who are known and beg for compassion? The answer is that the bill is footed by the many anonymous fellow citizens. They include the bulk of domestic consumers and taxpayers, the workers and firms who have to draw on overpriced inputs, and all those in the new industrial nations whose income and job opportunities are diminished if the rich countries resist structural adjustment. Seen in this light, the principle of free trade and non-discrimination, which stands in the way of protectionist industry policies, is a moral shield which protects the life opportunities of those we do not know. It deserves the rank of a universal principle to counter the influence of protectionist lobbies which are laying siege to governments. Those who advocate free trade are often derided as theoretical purists. But that criticism turns against the 'pragmatists' who raise it. Confused pragmatism grows of its own accord in the jungle of politicised interventionism. 'Purist theory' therefore may at least serve to give pragmatists, who earn their keep from representing particular interests, a bad conscience and thus serve as a corrective for their myopic judgments and all-too-pragmatic inclinations.

### **V. Markets and Morality in the Open Society**

Without at least an intuitive comprehension of the spontaneous order of the market, one cannot comprehend the ethics of the open society or explain it to others. Markets are certainly not perfect, but they are without doubt the greatest invention in human history. Markets were invented wherever individual property was safeguarded, and they spread where conditions were favourable, above all the ethical preconditions.

Economic ethics, which markets demand and generate, is apt to promote the self-responsibility and the spontaneous order of free citizens. This takes the weight off hierarchical structures like the state. It creates the scope for privatisation, deregulation and liberalisation. Bureaucrats and many a politician of course take a different position than the citizens who are now showing their disdain for politics. Mature, responsible citizens find themselves in a tussle with authorities that claim a right to regiment them. Where and to what extent economic morality will be able to replace governmental authority will ultimately be decided by the competition of locations. We should note in this context that the spread of global competition since the early 1980s, and even

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before, has been paralleled by a turn towards supply-side policies, that is policies which are aimed at liberating producers rather than controlling them.

Ludwig Erhard, when German Economics Minister, did not hesitate to preach economic ethics, rather than issuing decrees. He used to admonish the citizens to save and the business people to invest ahead of demand. He demanded discipline in wage demands from the unions and price discipline from industry. Thus, he hoped to suppress inflationary tendencies not by direct government controls, but by moral suasion. But that had probably little durable effect. Those at the receiving end of his admonitions gradually came to ridicule his moralising speeches and his posturing as 'the massage of our souls'. But they nonetheless felt that he took them seriously by his appeals and therefore counted him as one of the fathers of Germany's post-war success.

Social compacts and accords that remind those in power of their overall responsibilities are desirable in open systems which compete with each other. One does not have to be concerned about social accords when the winds of global competition sweep in, because internal cooperation will develop anyway. Once the winds of competition are blowing in from the outside, the insiders band together, antagonism wanes, and all begin to cooperate out of sheer necessity. In such an atmosphere there is advantage not only in overcoming class conflicts between capital and labour, but also between incumbents and immigrants. When this happens within firms, competition promotes efficiency. When this happens among nations or locations, all residents gain new opportunities and prosperity.

One can also hope that the competition of locations will give rise to a competition of moral systems and that this moral competition will lead to quality improvements. When we speak of morality here, we do not think of something temporary or superficial as is implied when people speak of 'morale', that is motivation and sentiment. Rather we mean ethical rules which deserve to be turned into universal principles. But we must put up a warning sign: morality is directed against the degeneration of locational competition into protectionism. Universal ethical principles of competition should above all induce us to oppose the subsidy race and industrial and agricultural protectionism which is the consequence of short-sightedness. It overlooks the long-term damage done by the discrimination against those who are unknown and in favour of those who are known to, and closely connected with, policy makers.

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The image of the cosmopolitan economic citizen lets one expect certain characteristics and modes of behaviour. One may describe the ideal type of the economic citizen (even as a poignant caricature) by about 100 adjectives and terms from the popular language. A list of these associative terms is attached, although it will have gaps.

There are still many words which remind us of the civic virtues and have positive connotations in popular culture. Linguists and literary critics may be able to tell us how the image of open-minded citizens has changed over time by analysing the language of the old and the young. That would offer us insights into future modes of thought and behaviour. A linguistic atlas that provides national regional and local information of this type might help us in rating locations for their assets of civic morality. This could supplement statistical information about murder and theft, fraud and corruption, accidents, strikes and many other such locational factors that define the social competitiveness of regions and nations.

Finally, a few words to sum up: locations have attributes which make them more or less attractive to mobile resources. The behaviour of the residents - more precisely, their economic ethics - is amongst the more important competitive factors. Just as tribal morality fits in well with the warmth of family life, so the global competition of firms and locations demands a morality of efficiency which is based on honesty. What is honest is decided in the image market which is also influenced by moral discourse. What has proven its worth is preserved, new concepts are tried out, successes are imitated, failures are rejected. Moral competition results from what Hayek called a 'discovery procedure' and Schumpeter a 'process of creative destruction'.

The global competition of locations has finished off socialism as a constructivist attempt to force tribal morality onto modern macro society. The universal principle of non-discrimination which is valid at the individual and the cosmopolitan levels has stood the test. Between the two poles on the social scale, the individual and global society - in a zone of tension with increasing chill - there are the family, the club, the neighbourhood, the city, the nation, the European Union, modern civilisation. Smaller communities will need more openness. These create moral ties for the individual who may accept them with gain or reject them out of a thirst for independence. But genuine independence is only enjoyed by those who accept many advantageous ties voluntarily and do so voluntarily out of self-discipline. The German poet Goethe put this concisely when he wrote: 'He who toys with life,

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will always remain in strife. He who does not take command of himself will remain a serf.

In locations, where such an attitude is conserved as a custom, there need be no great concern that economic morality will remain a competitive asset.

### **VI. Attributes of Civic Morality**

A responsible economic citizen is or should be

- Civil and honest;
- cultivated and sophisticated;
- loyal, obeying the rules and the law;
- disciplined and considerate;
- moderate;
- ethical;
- respectable;
- open and open-hearted;
- diligent; orderly; industrious;
- straightforward;
- reliable, punctual, if not punctilious;
- rationally calculating and therefore predictable;
- circumspect, faithful and caring;
- non-opportunistic in complying with contractual obligations;
- faithful to the customer and supplier;
- reliable in paying bills, solvent, ready to pay one's dues;
- creditworthy;
- enterprising, active, alert;
- courageous, strong-headed, ready to take up challenges;
- engaged, but not out of blind zeal;
- eager to compete, but without being spiteful;
- fair-minded;
- flexible, but not opportunistic,
- performance-oriented, but without gloating about his success;
- self-assured;
- self-interested but without narrow-minded greed;
- fraternal and compassionate out of an extended - self-interest;
- individualistic, but considering long-term interests of the small group;

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- patriotic out of a community spirit;
- cosmopolitan, non-discriminating, universally humane;
- incorruptible;
- innovative, open to the future, eager to learn and acquire knowledge, curious;
- tolerant, insightful, not arrogant;
- modest, economical, a person of independent means, self-responsible and self-reliant;
- helpful, unobtrusive;
- decent, tactful, candid;
- well-mannered;
- self-critical;
- generous;
- sober, balanced;
- factual, competent, unemotional;
- adaptable, imaginative;
- honourable, respected, of exemplary behaviour wise;
- sincere.

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# 28 To Help or Not to Help: The Samaritan's Dilemma Revisited

DIETER SCHMIDTCHEN

- I. Introduction
- II. The Samaritan's Dilemma
- III. Strategic Courage
  - 1. Iterated Game
  - 2. Dynamic One-Shot Game
  - 3. Delegating the Power of Decision
- IV. Conclusion

**Abstract.** Helping somebody may undermine his incentives to work. What Buchanan identified more than 25 years ago as the Samaritan's dilemma is basically a time-inconsistency problem. The paper discusses possible solutions of the dilemma such as punishment within an iterated game, reshaping the game in the direction of a dynamic one-shot game and the delegation of the power of decision to an agent. The paper shows that only the latter option works.

## I. Introduction

The Samaritan's Dilemma is one of Buchanan's articles written in – what he once called – his pessimistic working period. The essay characterized as an "essay in prescriptive diagnosis" (Buchanan 1977, p. 169) starts with the observation that modern man has become incapable of making the choices that are required to prevent his exploitation by predators of his own species, whether the predation be conscious or unconscious (see Buchanan 1977, p. 173). Modern man in twentieth-century Western Society has "gone soft": "His income-wealth position, along with his preference ordering, allows him to secure options that were previously unavailable. What we may call 'stra-

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tegic courage' may be a markedly inferior economic good, and what we may call 'pragmatic compassion' may be markedly superior." (Buchanan 1977, p. 173)

What is the prescription, the direction of reform and improvements? Buchanan's prescription consists of two parts: The first part is "an explicit recognition of the dilemma by those who are caught up in it" (Buchanan 1977, p. 173). The second part comes in, once this sort of recognition is passed: "(t)he players involved must, individually and collectively, act *strategically* instead of pragmatically" (Buchanan 1977, p. 173). What that means, is explicitly stated in the paper as "the choice of utility-maximizing rules for personal behavior as opposed to the retention of single period or single-situation choice options. Having once adopted a rule, the Samaritan *should not* be responsive to the particulars of situations that might arise. He should not act pragmatically and on a case-by-case basis" (Buchanan 1977, p. 177). Both, the choice of a rule and strictly following such a rule requires what Buchanan called "strategic courage". As with strategic moves in general (see Dixit/Nalebuff, p. 121), strategic courage purposefully limits the freedom of action, thereby altering the beliefs and actions of others in a direction favorable to the decisionmaker.

The final version of Buchanan's paper was prepared for presentation at a conference on Altruism and Economic Theory held in the early seventies. However, it seems to me that the prescriptive diagnosis presented in the paper is as topical today as it was at that time. What Buchanan identified as the Samaritan's dilemma reflects characteristics of the modern Welfare state. The number of those living on transfers has risen dramatically. And there is a widespread belief that the benefits in the modern welfare state are the very reason for undermining the incentives to work (see for a rigorous recent treatment of this subject Lindbeck, Nyberg, Weibull 1999). Thus, we have reason to reflect on what Buchanan wrote many years ago. However, there is another reason for doing so. The parts of the article quoted here extensively make clear that "The Samaritan's Dilemma" can be considered as being an early contribution to the literature on the time – inconsistency problem. Decisionmakers, recognizing that they will be tempted not to do what they announced to do must think of institutional designs making their announcements credible. Otherwise they will get caught in a trap by their own rationality. As Buchanan puts it: "The term dilemma seems appropriate because the problem may not be one that reflects irrational behavior on any of the standard interpretations." (Buchanan 1977, p. 173.)

The remainder of the paper is organized as follows: Section II presents Buchanan's model. It also deals with the question, in what sense the outcome of the interaction between the Samaritan and those in need of help can be considered being a dilemma. Section III discusses possible solutions of the dilemma such as punishment within an iterated game, reshaping the game in order to make it a dynamic one-shot game and the delegation of the power of decision to an agent. Section IV concludes the paper.

## II. The Samaritan's Dilemma

Buchanan models the Samaritan's dilemma as a two-by-two matrix game (see Buchanan 1977, p. 170; see fig. 1).

	B <sub>1</sub>	B <sub>2</sub>
A <sub>1</sub>	I 2,2	II 1,1
A <sub>2</sub>	III 4,3	IV 3,4

Fig. 1: The Active Samaritan's Dilemma

We have two players A and B: A is the potential Samaritan, B its opponent.

Player A has got two strategies:

A<sub>1</sub> =: do not help

A<sub>2</sub> =: help which could mean pay 30\$ to B as a transfer (gift).

Player B has also got two courses of action:

B<sub>1</sub> =: work

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$B_2$  =: do not work.

The pay offs are ordinal utility indicators, with A's pay off ranked first. We assume the matrix as well as rationality of the players being common knowledge. The game has one Nash- equilibrium in pure strategies, namely strategy combination  $(A_2, B_2)$ .  $A_2$  is the dominant strategy of the Samaritan. Knowing this  $B_2$  is the best reply of its opponent. B gets help and does not work. That is, in a nutshell, the result which many people lament being the typical feature of the modern welfare state.

Note, that the game represented by fig. 1 must be interpreted as implying imperfect information on the side of both players. In other words, the game is a simultaneous game. As a sequential game the player moving second would have to have four strategies. The Samaritan's dilemma can also occur if the potential Samaritan does not have a dominant strategy. This case is depicted in fig. 2 (see Buchanan 1977, p. 172).

	$B_1$	$B_2$
$A_1$	I 4,2	II 1,1
$A_2$	III 2,3	IV 3,4

Fig. 2: The Passive Samaritan's Dilemma

This game is set up by simply transposing the pay off numbers for player A as between cells I and III. The game has two equilibria, strategy profiles  $(A_1, B_1)$  and  $(A_2, B_2)$ . Buchanan calls the games presented in fig. 1 and 2 the active and passive Samaritan's dilemma, respectively. The reason is, that strategic behavior on the part of the potential Samaritan is always dictated in the fig. 1 game whereas in the case of fig. 2 strategic behavior "may be dictated only when a specific gaming situation is forced upon him by his oppo-

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ment" (Buchanan 1977, p. 174). That means, if by whatever reason the strategy profile  $(A_2, B_2)$  happens to be the outcome of the game.

From the perspective of game theory strategy profile  $(A_2, B_2)$  is an example of a dilemma on the side of player A because he cannot implement the outcome he prefers most. Thus, both games represent a personal dilemma and not a social dilemma, if the term social dilemma refers to an equilibrium which is Pareto inefficient. In the game of fig. 1 the equilibrium is Pareto-efficient (as well as cell III). The same holds for the two equilibria in the game of fig. 2.

Of course, one is wondering whether player A with preference ordering as shown in fig. 2 should be considered as being a Samaritan at all, since he prefers an outcome most, in which he does not help. However, his preference ordering might reflect features of a Samaritan because helping is the preferred option in case of B's choice not to work.

The character of player A as revealed by his preferences in the fig. 1 game needs some further comments. As can easily be seen, helping B is A's dominant strategy. Whatever B does to help is preferred by A to not doing so. Since helping has a higher pay off for A whatever B chooses to do, player A can be viewed as an unconditional Samaritan. A's ranking of cell III and IV compared to cell I and II, respectively, mirrors the ranking of these cells by B. That is what we would expect from somebody having altruistic preferences. However, A's character is much more complex as becomes clear by a comparison of cell IV and III. A's utility increases by moving from cell IV to III. With respect to these cells the Samaritan does not care about B's preferences. Although B would suffer an utility loss by the move from IV to III this move increases A's utility. This increase could be explained in several ways: B's work contributes to social product and A can participate in that. Or: From A's point of view being confronted with lazy-bones is a bad, which can be considered as a negative externality lowering his utility. Note, that in the case mentioned first the personal dilemma of the Samaritan would also be a social dilemma.

### III. Strategic Courage

In this section we discuss potential means for the resolution of the Samaritan's dilemma. The focus will be on punishment within an iterated game,

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the sequentialisation of the one shot game and the delegation of the power to a decision to a third party. Attention will be restricted to the active Samaritan's dilemma.

### 1. Iterated Game

The game of fig. 1 can be considered being a stage game that is repeated a number of times. Under the assumption that players can observe the outcomes of previous games before playing a later stage game, players can condition their optimal actions on the other players' behavior in the past. Since this opens up the possibility of punishing and rewarding another player one might ask whether the Samaritan can shape the incentives of his opponent in such a way that he decides to work, i.e. to choose action  $B_1$ . Buchanan already mentioned the punishment strategy opened up by the iteration of the stage game. He argues, that in order to induce B to choose  $B_1$ , i.e. to work, the Samaritan must choose row 1 rather than row 2 when player B is observed or predicted to select column 2 (see Buchanan 1977, p. 171). But he concludes: "This choice will 'hurt' A. Admittedly, the utility losses may be short-term ones only, and there may be offsetting long-term utility gains in a sequential game, but once the trade-off between short-term utility and long-term utility is acknowledged to be present, we must also acknowledge that A's subjective discount rate will determine his behavior. If this rate is sufficiently high, A may choose nonstrategically, even in the full recognition of the game situation that he confronts." (Buchanan 1977, p. 171.)

Modern game theory supports the view that the punishment strategy will not work.

- If the game is finitely repeated backwards induction shows that action profile  $(A_2, B_2)$  will be the outcome of each stage game. The reason is, that  $A_2$ , i.e. to help, remains A's dominant strategy in each stage game. The Samaritan's Dilemma still exists.
- In the infinitely repeated game things look better at first glance. One might be reminded of the Folk-Theorem according to which a whole bunch of subgame-perfect Nash equilibria exist if the discount factor is sufficiently close to one and the Nash equilibrium of a finite, static game of complete information is not pareto-efficient (see Gibbons 1992, p. 88-99). In this case each point in the Pareto-region can be implemented as a subgame perfect equilibrium.

Unfortunately, the Pareto-region of the Samaritan's Dilemma game is empty, because the Nash-equilibrium is pareto-efficient. Thus, there is only one subgame-perfect equilibrium in the infinitely repeated game, namely  $(A_2, B_2)$ . Thus, it is impossible to overcome the dilemma by infinitely repeating the stage game.

If with iteration of the stage game the dilemma cannot be resolved, the solution – if any – must be found in the alteration of the stage game. We will now discuss two alternatives. Firstly, the design of a dynamic one shot game. Secondly, the involvement of a third player.

## 2. Dynamic One-Shot Game

In a dynamic one-shot game the interaction of the players is inherently dynamic in the sense, that some players can observe the actions of other players before deciding what to do. Let us model the interaction between the Samaritan and its opponent as a two-period game, with one player moving in period one and the other in period two under the assumption that the second mover observed the decision of the first mover. Consider fig. 3. The Samaritan A as the first mover has to decide whether to help ( $A_2$ ) or not to help ( $A_1$ ). B having observed A's decision can choose between work ( $B_1$ ) and not to work ( $B_2$ ). The pay offs are from fig. 1. Backwards induction shows, that it is rational for the Samaritan to choose  $A_2$ , i.e. to help, expecting that his opponent plays  $B_2$ . As the equilibrium path represented by doubled edges reveals the Samaritan's Dilemma still exists.

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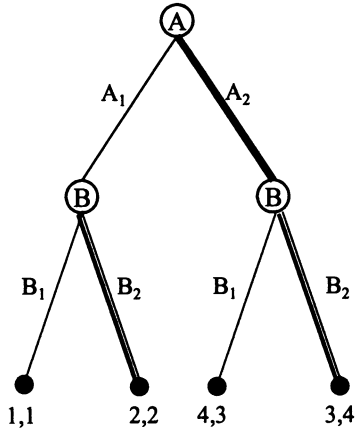


Fig. 3: Dynamic One-shot Game  
(Samaritan as first mover)

If, alternatively, the opponent moves first, the outcome of the game remains the same as an analysis of fig. 4 makes clear.

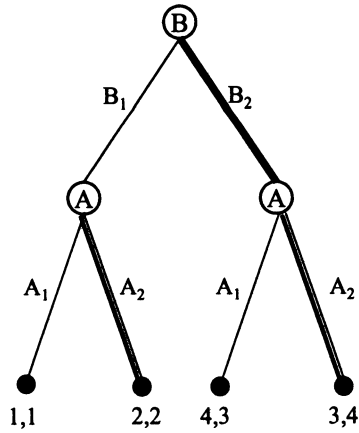


Fig. 4: Dynamic One-shot Game  
(Samaritan as second mover)



Since in the last stage of the game the Samaritan chooses  $A_2$  the opponent chooses  $B_2$ , i.e. not to work. It follows, that sequentialisation of the one-shot game with the preference ordering of fig. 1 does not resolve the Samaritan's dilemma. The reason is, of course, that "help" remains the dominant strategy of the Samaritan.<sup>1</sup>

We can now state a general result: It is impossible to resolve the Samaritan's dilemma given that only the Samaritan and its opponent are the players in the game and given their preference orderings.

### 3. Delegating the Power of Decision

If the Samaritan would announce in the one-shot game of fig. 1 that he will only help his opponent if the latter chooses  $B_1$ , this announcement would not be credible. As Buchanan already pointed out in his article credibility can be gained if the Samaritan locks himself into a strategic behavior pattern in advance of any observed behavior (see Buchanan 1977, p. 176).

One way to accomplish this is to "delegate the power of decision in particular choice situations to an agent, one who is instructed to act in accordance with the strategic norms that are selected in advance." (Buchanan 1977, p. 177.) Buchanan argues that the "agency device" serves two purposes simultaneously: "First, the potential parasite is more likely to believe that the agent will behave in accordance with instructions. Second, by delegating the action to the agent, the Samaritan need not subject himself to the anguish of situational response which may account for a large share of the anticipated utility loss." (Buchanan 1977, p. 177.) Whereas the latter purpose does not raise any queries the first one does. Why should the potential parasite believe that the agent will behave in accordance with instructions? Whether the agent will do what the Samaritan expects him to do depends on the incentives generated by the contract governing their relationship. Without knowing the details of the contract as well as the utility function of the agent the potential parasite might not be induced to behave the way the Samaritan would like.

What we have here is a trilateral agency relationship. The Samaritan acts as the principal, the agent is the agent as far as the Samaritan is concerned but

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1 With the preference ordering of fig. 2, however, the Samaritan's dilemma can be overcome, if the Samaritan is the first mover. He will choose  $A_1$  and his opponent will optimally react by choosing  $B_1$ , i.e. to work. It is straightforward that with the opponent being the first mover the equilibrium play will be  $(B_2, A_2)$ .

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he is at the same time the principal in relation to the potential parasite. Let us analyze this three players game with the help of a model.

A (Samaritan) offers D (agent) the following contract: I promise to pay \$  $T > 0$  to you for you watching the behavior of potential parasite B. If you see B working, help; if you see B not working do not help. Help means to give B \$30. I entrust you with \$30 at the moment you accept the contract. It is your duty to pay \$30 back in case of breach of contract. Payment  $T$  is due after you have done your job. We assume for simplicity that the terms of the contract are verifiable in court and that filing suits is costless.

The game tree of the three players Delegation game is depicted in fig. 5.

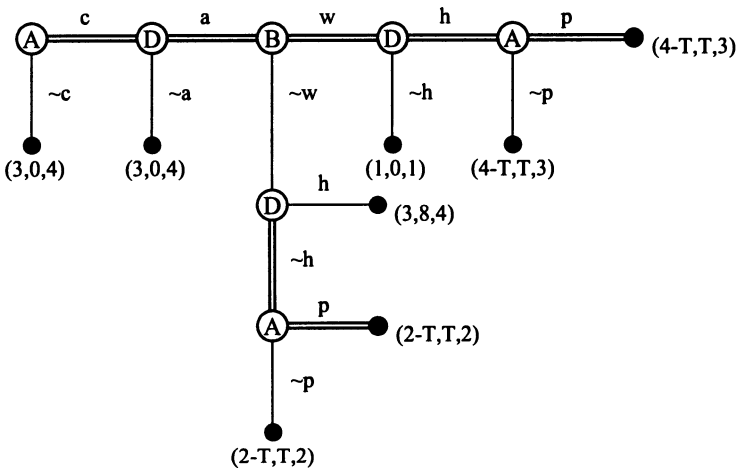


Fig. 5: The Delegation Game

The actions of the players are denoted as follows:

- c =: offer contract
- ~c =: do not offer contract
- a =: accept contract
- ~a =: reject contract
- w =: work

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- $\sim w$  =: do not work
- $h$  =: help
- $\sim h$  =: do not help
- $p$  =: pay agent
- $\sim p$  =: do not pay agent

The subgames representing court involvement are omitted.

The pay offs are indicated at the endnodes in the order (A, D, B). We assume that the pay offs are the monetary equivalents of utility; the reservation wage of the agent D is normalized to zero, and  $4 - 3 > T > 0$ .

In this game players can either move across or down. The sequence of the moves starts with A's decision to offer a contract or not. D is next to decide whether to accept the contract or not. B as the third mover is confronted with the choice between working and not working. Then it is again D's turn; but now he has to decide whether to help or not to help. The final decision is taken by A, having to choose whether to pay T or not. Since the court-subgames are omitted some remarks regarding the pay offs of the plays with court involvement seem in order. There are four plays of the game with court involvement.

- (c, a, w, h,  $\sim p$ )

D did stick to the contract terms but A rejects to pay T. As the pay offs indicate the court perfectly enforces the contract: A pays T to D.

- (c, a, w,  $\sim h$ )

In this case D breaches the contract. A files suit, in order to get the money back that he entrusted with D.

- (c, a,  $\sim w$ , h)

As in the previous case D breaches the contract. He decides to help although B does not work. A files suit, in order to get the money back that he entrusted with D.

- (c, a,  $\sim w$ ,  $\sim h$ ,  $\sim p$ )

This case is similar to the case mentioned first.

The pay offs of the play (c, a,  $\sim w$ ,  $\sim h$ , p) need some further comments. D sticks to the contract terms and does not help. It is assumed, that he gives A the money back entrusted with him. This result seems plausible given our

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assumption of a perfect and costless court system.<sup>2</sup> As can be seen, A is indifferent regarding  $p$  and  $\sim p$  at both his upper right and lower decision node. To break the tie we assume that he always chooses the options that does not imply court activities.

Assuming common knowledge of rationality as well as of the game tree we can derive the subgame perfect equilibrium by backwards induction. This equilibrium is given by the play  $(c, a, w, h, p)$ , leading to the pay off vector  $(A, D, B) = (4 - T, T, 3)$ . The actions chosen by the players are indicated in fig. 5 by doubling the edges.

The backwards induction reasoning is as follows starting with the upper part of the game. In the last stage of the game A chooses  $p$  given our rule for breaking ties.

Since  $T > 0$  D chooses  $h$ .

Since  $3 > 2$  B decides to work, thus preventing that the play of the game moves downwards.

Since  $T > 0$  D accepts the contract.

Since  $4 - T > 3$  A offers the contract.

As it turns out, Samaritan A can implement his first best option by delegating the decision to an agent. Given the contract and given the workability of the court system the agent acts according to the instructions of the Samaritan.

Of course, there is one question left. If the court system works perfectly and costlessly why did not the Samaritan conclude a contract with B, thereby making B his agent? By doing this he could save the payment  $T$ , which – in the case of success - would give him higher utility than the outcome of the above mentioned game. However, as it turns out this is an example of fallacious thinking. Whereas in the three players game A has an incentive to sue D in a case of breach A would never bring suit against B. Moreover, we have reason to believe that A will never accept such a contract.

To illustrate:

In the three players game A has an incentive to sue D if D breaches the contract. We consider two cases, action profiles  $(w, \sim h)$  and  $(\sim w, h)$ . If D does not help although B decided to work (action profile  $(w, \sim h)$ ), A brings suit in order to get the money back entrusted with D. The reason is that with a

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<sup>2</sup> As has been shown elsewhere (KIRSTEIN/SCHMIDTCHEN 1997) contractual compliance can be guaranteed in a costly system and with judges committing errors if their detection skills are positive. The latter concept is based on HEINER (1983).

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suit he gets pay-off 1 whereas without suit he would get (1 minus utility of the money entrusted with D). He also refuses to pay T. That is why D helps given B decided to work.

The more interesting case however is given by the action profile ( $\sim w$ , h). Here A has the right and the incentive to refuse paying T as well as to get the money back entrusted with D. If D would not give the money back A would receive utility (3 minus utility of the money) instead of 3. D's pay-off S is negative if he is able to pay back the money. If D's budget constraint does not allow for that his pay-off would be zero and A's pay-off would go below 3. Since  $T > 0$  D decides not to help, thereby giving B the incentive to work.

What would happen, if A would conclude a contract with B stating that B promises to work and A pays a certain amount of money?

The first question is whether B has an incentive to accept such a contract. The answer is straightforward: B knows that he gets help anyway, therefore he has no incentive to accept. But assume, for whatever reason, B stepped in and furthermore that the money is paid in advance. Since B decides not to work, we have a breach of the contract. Though being confronted with a breach of contract A would not bring suit against B in order to get the money back, given his preference ordering.

Can we expect a different outcome if the contract states that B promises to work and that the money will be paid after B decided to work? B, knowing that help is A's dominant strategy, will breach the contract, because he can be sure that A will pay the money. The contract does not rule out this possibility.

That a contract between A and B will not be enforced in the case of breach is not surprising. The existence of an option to file suit does not imply the incentive to choose this option. The incentive structure of the contract game between A and B is exactly that of the two versions of the one-shot dynamic game analysed above.

What about A bringing suit in order to force B to work? Here the problem arises, whether the legal order allows for forced labor. If not there is no reason to bring suit. If forced labor is allowed, B would not accept the contract in the first place, knowing that the Samaritan will help anyway.

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### IV. Conclusion

It could be shown in this paper that the Samaritan's dilemma cannot be solved if the game remains a game played only by the Samaritan and its opponent. Neither iteration of the simultaneous stage game nor reshaping it in the direction of a one-shot dynamic game nor concluding an enforceable contract work. There is only one way out of the dilemma the delegation of the power to the decision. However, the courts must work in a sufficient manner in order to get the incentives right. With an imperfect court system things might look different.

The analysis has been restricted to interactions with only one Samaritan. However, there may exist more than one potential Samaritan. If all would decide to hire an agent on the terms discussed in the above section the Samaritan's dilemma could be prevented to become a public or social matter. However, if the population of Samaritans is heterogeneous, "enlightened" Samaritans, which have hired an agent, might now have to compete with those having chosen the "soft option". With "potential parasites" preferring to get help from the latter group, something described by Gresham's law result. "Bad" Samaritans drive the "good" ones out of the market. This process might be fuelled by the possibility to give the money to the poor that otherwise would go to the agent. What we have is a kind of a collective prisoner's dilemma, which requires collective action to be overcome.

In modern societies government steps in as the agent. Can we trust government? In a democracy vote shares are decisive. Even if a large number of Samaritans would opt for the strong option, one might ask whether they have sufficient voting power. In any case Buchanan has been sceptical 25 years ago, as can be read out of the following quote: "Government do little more than reflect the desires of their citizens, and the taking of soft options on the part of individuals should be expected to be accompanied by an easing up on legal restrictions on individual behavior." (Buchanan 1977, p. 185.)

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## **29 Constitutional Economics and Ethics – On the Relation Between Self-Interest and Morality<sup>1</sup>**

VIKTOR J. VANBERG

- I. Introduction
- II. Action Interests, Disposition Interests, and Constitutional Interests
- III. Moral Order and Consensual Constitutional Interests
- IV. Constitutional Interests and "Ordnungspolitik" (Constitutional Politics)
- V. The Market and Morality
- VI. Consensus and the Choice of Rules

### **I. Introduction**

Fundamental to the economic approach to human behavior is the notion that people are motivated by self-interest in the sense that, if faced with a choice among alternative courses of action, they do what, in their view, best serves their own interests. Ethics, on the other hand, is based on the idea that there exist rules of moral conduct, and that people are not permitted simply to pursue their own interests, but are obliged to conform to these rules.

It seems evident that what serves people's self-interest need not always coincide, in fact, often clashes with what they ought to do from a moral point of view. Such conflicts between morality and self-interest are presumably the key reason for the often encountered view that economics and ethics not only have little in common, but that there exists a "categorical difference between the ethical and economic perspective" (P. Ulrich 1996, p.30).

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In what follows, I hope to show that this notion of a "categorical difference" needs to be revised, at least in regard to the kind of economic perspective that has been advanced, in somewhat different but compatible ways, by the research program of the Freiburg School, founded by economist Walter Eucken and jurist Franz Boehm (Eucken 1990; Vanberg 1998 a) as well as by the paradigm of Constitutional Political Economy, initiated by James M. Buchanan (Buchanan 1990; Vanberg 1998b, 1999).<sup>2</sup> The perspective that they share is, to be sure, not entirely novel in economics. It can actually be traced back to Adam Smith's concept of political economy as a "science of legislation," a science that can provide guidance to those who are to choose the rules for a society (Vanberg 1994, p. 5).

Like the political economy of Adam Smith, the constitutional economics approaches of Eucken and Buchanan essentially focus on the development of desirable rules for human coexistence and cooperation, which inevitably brings them into systematic proximity with the domain of social ethics, which is concerned with the moral rules people should observe in their dealings with one another. When it comes to assessing these rules we find that constitutional economics arguments, which refer to individuals' interests, and ethical arguments, being based on criteria of moral desirability, are far more closely related than the common perception of a conflict between morality and self-interest suggests. In fact, what may appear as an irreconcilable conflict at the level of particular actions appears in a different light if we look at the level of rules and relate the question which rules are desirable from an ethical perspective to the question which rules are desirable from the self-interest perspective of the individuals whose coexistence and cooperation is to be governed by them.

### **II. Action Interests, Disposition Interests, and Constitutional Interests**

Based on a set of conceptual distinctions summarized in the table below, I shall show how, in their respective approaches to the issue of what are desirable rules of human coexistence and cooperation, the constitutional econom-

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2 On the commonalities between the *Ordnungsoekonomik* of the Freiburg School and Buchanan's Constitutional Political Economy see VANBERG (1988; 1997a).

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ics perspective and the ethical perspective can be compared to each other. The table distinguishes three levels, at which an ethical and economic perspective can be applied: 1) the level of particular action, 2) the level of individual rules of conduct or behavioral dispositions, and 3) the level of social rules. In columns 1 and 2 the relevant ethical and economic issues are specified for each level. Column 3 refers to the constitutional issue of how to create conditions which make ethics and self-interest compatible.

	<i>Ethical perspective</i>	<i>Economic (self-interest) perspective</i>	<i>Constitutional perspective</i>
<i>Level of particular actions</i>	Which choice of action is morally right?	Which choice of action serves the agent's interests?	Can conditions be created in which the morally right choice always coincides with the agent's interests? (unsolvable problem)
<i>Level of individual behavioral dispositions</i>	Which behavioral dispositions can be defined as ethical?	Which behavioral dispositions serve the agents' interests in the environment in which they live?	Can conditions be created in which adopting ethical dispositions serves the agents' interests? (solvable problem)
<i>Level of social rules</i>	What rules of social conduct are ethically desirable?	Which social rules serve agents' constitutional interests?	Can conditions be created in which the agents' constitutional interests coincide with moral rules? (solvable problem)

The definitions in the table are based on the idea that the key to clarifying the relationship between self-interest and morality, or between economics and ethics, is to distinguish various interest levels. If, as in the table, we distinguish between *action* interests, *disposition* interests, and *constitutional* interests, it should become apparent that, while a conflict between morality

and self-interest may be inevitable at the level of particular behavioral choices, this is no longer so when we look at the level of dispositions and social rules, asking the question: which dispositions may serve a person's interest, and under which social rules may a person wish to live? It is easy to envisage specific choice situations where an action that directly serves a person's own interests contradicts what he should do from an ethical point of view. Indeed, it is scarcely possible to envisage a world in which this conflict between morality and self-interest would not exist. Yet, things appear somewhat different at the level of general behavioral dispositions, and very different at the level of constitutional interests.

The evidently accurate observation that individuals may face conflicts between self-interest and ethical imperatives in particular choice situations, often leads to the rash conclusion that a willingness to put one's own interests last is the sign of moral behavior. If, like this, we assume from the start that morality is a question of *motivation*, there is no point to further investigating the relationship between the economic perspective, which is based on the assumption that behavior is generally self-interested, and the ethical perspective. If morality is defined in motivational terms, an unbridgeable gap between morality and self-interest is created by definition, with the effect that economic and ethical perspectives must seem inherently irreconcilable.

The issue of the relationship between self-interest and morality is only worth exploring if one adopts a *behavioral* view of morality, i.e. a view that does not focus on an action's underlying (and unobservable) *motivation*, but on whether the empirically observable behavior coincides with specifiable norms of ethical conduct (Vanberg 1997b). According to the behavioral view, morality does not require the individual to abandon the pursuit of self-interest, but only to abandon the pursuit of self-interest by immoral means. Although a behavioral concept of morality does not eliminate the potential conflict between self-interest and morality, it does not exclude by definition alone the possibility that self-interested behavior can be moral and vice versa. By insisting on the distinction between the motivation and the factual consequences of human actions, it also alerts us to the fact that non-self-interested or altruistic motivation by no means guarantees a behavior that, in terms of its actual consequences, we would consider morally desirable.

If we regard the function of morality as providing a desirable frame for human coexistence and cooperation, the behavioral concept of morality is surely the more appropriate alternative. According to such a concept, persuading people to abandon self-interest is neither necessary nor sufficient for

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solving the problem of moral order. Rather, the problem can only be solved by creating structural conditions which induce people to act morally out of their own interest, conditions which reconcile self-interested behavioral *motivation* and ethical behavioral *conduct*.

To be sure, the problem of creating a moral order would in fact be an unsolvable task if conditions first had to be created (row 1, column 3 of the table), whereby - in concrete decision-making situations - the most personally advantageous alternative always coincided with the morally required one. The nature of the problem changes, however, if instead of asking whether, in particular choice situations, it is in the interest of an individual to behave morally, we ask whether it promotes his own interests to be *generally disposed* towards complying with moral rules, i.e. not to calculate in each single case if moral behavior is advantageous or not. The comparison that at this level is of relevance for the relationship between morality and self-interest is no longer concerned with the consequences of single, specific choices, but with the total sum of personal advantages and disadvantages that result from a "moral disposition" over a relevant period of time, i.e. from the general willingness to respect the rules of moral conduct, independently of the specific circumstances of particular choice situations. In other words, the relevant comparison is between the overall pattern of payoffs that results from a moral disposition, compared to the pattern of payoffs a person would experience if she had *other general dispositions* or simply behaved in a discretionary manner in every single case.

In everyday language we refer to behavioral dispositions when we talk of a person's character. Accordingly, the issue at hand can also be expressed in terms of the question whether - and if so, under which conditions - a moral character can be to a person's advantage. This, of course, raises the further question of how the implied notion of a "calculus of advantage" can be theoretically defined at the level of behavioral dispositions. Obviously, we can hardly speak of a genuine "choice" between alternative behavioral dispositions (or character traits) in the normal sense in which we speak of a choice between alternative courses of action. Behavioral dispositions are much more the product of subconscious learning processes than a subject of deliberate choice. They can, therefore, not simply be adopted or rejected as a result of a conscious calculation of their advantages and disadvantages, even though a person may, of course, wish to adopt certain dispositions and make efforts to develop the respective character traits. If we assume, as certainly we must, that some kind of "calculus of advantage" occurs at the level of dispositions,

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the "accounting" of the advantages and disadvantages of relevant alternatives at that level must clearly be based on something other than deliberate calculation. In order to allow for such a modified notion of a "calculus of advantage," the conventional economic model of rational choice will have to be expanded or revised, for instance along the lines of Ronald Heiner's theory of "rule-governed behavior" (1990). An "economic," in the sense of interest-based, explanation of moral dispositions developed along these lines would proceed in two steps. The first step would be to explain, as Heiner's theory does, why rule-following behavior can produce greater long-term benefits than discretionary decisions from case to case. The second step would consist of determining the conditions in which a *moral* disposition can yield greater rewards than potential alternative dispositions (Vanberg 1994, chapters 1, 2 and 3; Vanberg and Congleton 1992).

### III. Moral Order and Consensual Constitutional Interests

The crucial point in the distinction between the level of behavioral choices and the level of general behavioral dispositions is the following: It is noticeably easier to create and sustain a moral order if one is not dealing with "homines oeconomici," who in every single instance choose the most personally profitable course of action, but with rule-following individuals who, even though they do, indeed, pursue their own interests, do so on the basis of general behavioral dispositions which they have found to work to their overall advantage. It would go beyond the scope of this paper to discuss the issue of what kind of learning process is required to process information on the relative benefits of alternative behavioral dispositions.<sup>3</sup> What matters here is that the conditions which render it profitable for rule-following agents to possess *moral* dispositions (row 2, column 3 of the table) are far easier to create than conditions that ensure that for discretionary case-by-case maximizers the most profitable course of action generally coincides with what is morally required. To be sure, the potential conflict between morality and self-interest continues to exist at the level of general behavioral dispositions, since moral

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3 A most instructive discussion of this issue can be found, for instance, in J.H. Holland (1995, pp. 41ff.).

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dispositions are by no means always "rational," in all kinds of environment. However, the problem of creating an environment in which people can be "rationally" moral is a solvable problem.<sup>4</sup> Indeed, it is a problem that every society must solve if a moral order is to be sustained.

The relationship between morality and interests appears in yet a different light if we turn to the third level, i.e. the level of social rules, and examine people's *rule* or *constitutional interests*, i.e. their preferences with regard to the "rules of the game" that they wish to see enforced in the society in which they live. One can meaningfully speak of constitutional interests only in relation to specific, definable communities or social units, which a person belongs to and where she can want certain rules to be enforced. People are generally affiliated to a variety of overlapping groups or communities, each one internally governed by specific rule systems (formal and/or informal): these range from the family and private associations, various kinds of polities at the sub-national, national or supranational level, to the largest group of all, i.e. the world community. For each of these units, we can ask which general rules reflect the constitutional interests of its members.

As regards the constitutional interests that people hold in their various groups, associations or communities, a distinction of key significance in the present context is that between *consensual* constitutional interests and interests in *privileges*. When people consider which rules serve their own interests, the first to spring to mind are likely to be rules that grant them some privilege or other, i.e. offer special personal advantages. And, as far as they are in a position to choose and enforce social rules without considering the interests of other members, we should expect self-interested individuals to be tempted by their interests in privileges. Interests in privileges are by their very nature non-consensual. They may be enforced by means of fraud or coercion, but are no basis for a constitutional order to which all participants can voluntarily agree, with a clear understanding of their own interests.

In contrast to non-consensual interests in privileges, *consensual constitutional interests* aim at rules that are desirable and acceptable to all parties involved. The key contention of this article can be stated as follows: the informed constitutional interests shared by all members of a group or community define the very rules which, from an ethical perspective, are morally

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4 See VANBERG (1994, pp. 51ff.) for a discussion of the (seemingly paradoxical) question: "Can it be rational to be *always moral* if it is *not always rational* to be moral?"

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desirable for that group. The adjective "informed" is added in order to account for the fact that the relationship between the enforcement of specific social rules and the resulting pattern of outcomes may be complex and not immediately obvious, and that, because they are not fully aware of the real relationships, people may be prompted to endorse rules they would reject if they were better informed about their factual working properties. What must be assumed to be of normative significance, therefore, is their informed agreement.<sup>5</sup>

Just as the question of which rules are the subject of consensual constitutional interests can be meaningfully discussed only in relation to specified groups, the question of which behavioral rules qualify as moral rules can, according to the interpretation proposed here, properly be answered only if we specify the relevant group of reference. The (group-) relativity of morality implied in such a notion is of less impact than it may first appear. It implies no limitation or restriction whatsoever with respect to what one may consider the relevant level of moral commitment, be it a local community or humankind. It only requires that one specifies with regard to what group or community a rule is claimed to qualify as a moral rule. How the appropriate reference group is to be defined depends on the nature of the issue one is interested in.

The argument that rules reflecting the consensual constitutional interests of all members of a group correspond to the rules that are morally desirable for that group, must be understood in a dual sense. On the one hand, it is meant as a proposed definition, i.e. it implies that the term morality can thus be meaningfully interpreted and expressed in operational terms. On the other hand, it is meant as the empirical hypothesis that both our general understanding of morality and major philosophical concepts of morality, as far as they are concerned with the issue of desirable rules for human coexistence and cooperation, can essentially be interpreted in terms of this concept or are at least compatible with it.

I suppose that many of the major ethical doctrines do in fact, with their respective definitions of the attributes of moral rules, refer to criteria which are identical or very similar to what has been defined here in terms of consensual constitutional interests. This evidently applies to concepts which see the essential criterion of moral rules in their impartiality and universal applicability or, as the discourse ethics of H.O. Apel and J. Habermas, in the

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5 On this issue see pp. 11ff. below.

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"Konsensfähigkeit für alle Betroffenen" (acceptability to all parties) (Apel 1997, p. 191).<sup>6</sup> This is also true for all concepts which - like the moral philosophy of David Gauthier (1986)<sup>7</sup> - in one form or another, view moral rules as behavioral constraints, which enable people to realize mutual gains from cooperation in cases where an unconstrained pursuit of self-interest would exclude such gains, or would even result in direct mutual damage. Donald Campbell (1986, p. 171) similarly focuses on the issue of constitutional interests when he states that the rules of morality reflect our preferences with respect to the behavior of *others*, i.e. our interests in how they should behave. Obviously, the direct implication of this interest is only that we wish *others* to be bound by such rules. Yet, where rules cannot be unilaterally imposed but have to find agreement among equally rational agents, these interests in how others should behave can be implemented only as mutual or reciprocal commitments (Baurmann 1996, pp. 139ff.; Buchanan 1962, p. 312; Homann and Blome-Drees 1992, p. 44).

### **IV. Constitutional Interests and "Ordnungspolitik" (Constitutional Politics)**

The constitutional economics concept of consensual constitutional interests is based on the idea that people can reap mutual benefits by jointly committing to suitable rules of the game. The key idea of this approach is that the notion of "gains from trade," familiar from the economic concept of voluntary market exchange, is generalized to agreements on rules, interpreted as voluntary "exchanges" of self-binding commitments (Buchanan 1991, pp. 81ff.; Vanberg 1999). To be sure, the constitutional interests referred to here merely entail the desire to live in a community in which the rules in question are enforced. This desire alone does not per se generate an interest in personally conforming to these rules. In other words, the *constitutional* interest in seeing rules *enforced* in one's community does not automatically generate an

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6 HABERMAS (1991, p. 32): "Jede gültige Norm muß der Bedingung genügen, daß die Folgen und Nebenwirkungen, die sich aus ihrer *allgemeinen* Befolgung für die Befriedigung der Interessen *jedes* Einzelnen voraussichtlich ergeben, von *allen* Betroffenen zwanglos akzeptiert werden können."

7 See VANBERG (1994, pp. 54ff.).



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*action-interest in conforming to them.* Rational agents will recognize, however, that their constitutional interest in living in a community where certain rules are enforced can become effective only if conditions are in place that ensure a sufficient direct interest in rule-compliance among the parties involved. Therefore, they should have a common interest in creating such conditions where necessary.

It is the task of *Ordnungspolitik* (constitutional politics), on the one hand, to identify and implement rules which serve the consensual constitutional interests of the members of a community and, on the other hand, to create conditions which generate sufficient interest in complying with these rules. This is what Walter Eucken (1990, p. 366) had in mind when he argued that the "coordination of individual and collective interests is the task of *Ordnungspolitik*." As noted before, to ensure sufficient interest in adhering to moral rules does not require that the utility-maximizing and the moral course of action coincide for all agents in every single choice situation. This would in fact be an unsolvable task. What is required is that conditions are created which allow people to be "rationally" moral in the sense that they can trust that by respecting moral rules they serve their own overall interests and do not systematically and permanently put themselves at a disadvantage.

Eucken (1990, p. 368) refers to this issue when he notes that "it is unfair to require people to do what can only be accomplished by the economic constitution: to create a harmonious relationship between individual and collective interests." If people are systematically and constantly penalized for behaving "morally," i.e. in a socially desirable manner, it means that the general system contains flaws that cannot be offset by appealing to people's willingness to make personal sacrifices. In fact, people who are particularly open to such appeals would only expose themselves to exploitation by more cynical agents (Vanberg 1987). And even if everyone could be motivated to make moral sacrifices, a moral system based on this type of willingness would always be vulnerable, since it would not have any defense against "immoral invaders," to whose exploitative tendencies it would only provide a particularly profitable niche.

According to what has been argued above, the ethical question concerning the rules of a moral order is essentially the same as the constitutional economics question concerning rules that reflect the consensual constitutional interests of the parties concerned. If one accepts this argument, one must regard behavior as moral as long as it is in accordance with rules of the game that are desirable for, i.e. in the consensual constitutional interest of, all per-

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sons involved. This fact is of special significance since the moral intuitions of people may not always correspond with their consensual constitutional interests.

Constitutional, that is rule-related interests are *derived* interests, in the sense that it is not the rules per se that interest us, but their working properties or their effects, i.e. the pattern of outcomes that result from alternative rule systems. The connection between the "order of rules" and the resulting "order of actions" (Hayek 1969) is often complex and not at all obvious. Which rules people believe to serve their interests depends on their explicit and tacit, more or less adequate theories about what outcomes will result from potential alternative rules, and how they will be personally affected. Accordingly, people's understanding of what is in their consensual constitutional interest depends on their explicit or implicit expectations concerning the working properties of alternative rule regimes. This means that there is no guarantee for their moral intuitions always to coincide with their "informed" constitutional interests, i.e. the interests that they would hold if aware of the actual functional characteristics of the rules in question. It seems that discrepancies between spontaneous moral intuitions and informed constitutional interests are one of the main causes of the widespread moral distrust by which the competitive order of the market is often met.

### V. The Market and Morality

The rules of the market system are rules for the interaction of an - in principle, unlimited - number of people, who are not related by personal ties or mutual attachment, but nevertheless wish to enjoy the mutual benefits that can be reaped from voluntary exchange and cooperation. By contrast, people's moral intuitions must be expected to be primarily shaped by the experience of living together in small groups, where "experience" is to be interpreted in a double sense, as the "experience" that, in a metaphorical sense, the species "homo sapiens" has undergone over its evolutionary history, and the experience that, in the ordinary sense, an individual person undergoes through his life time. The evolutionary history of the species was, up to roughly ten thousand years ago, marked for countless generations by the conditions of life in small hunter/gatherer groups. Ten thousand years are too short a time span for significant changes to occur in biological evolution. We

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may conclude, therefore, that our *genetic* makeup - including our "moral instincts" - is adapted to these primordial conditions, and not to the conditions of life in modern extended societies.<sup>8</sup> As regards the socialization history of individual persons, that too is predominantly shaped by the conditions of life in small groups - the family, school, the workplace, so that we must assume that the acquired behavioral dispositions of human beings - including their learned moral intuitions - are primarily adapted to the conditions of life in such intimate groups. Yet, the "moral instincts" and "moral intuitions" that are essential for cooperation in such groups are by no means necessarily adapted to the problems that have to be solved in order to sustain a mutually advantageous system of cooperation among a large number of virtual strangers. The creation of such a system is, however, precisely the function of the rules of the market. Needless to say, some of the behavioral rules governing cooperation in small groups will also be essential for market cooperation as well. Yet, some of the moral principles (Hayek refers specifically to notions of "distributive justice") that may be functional in the context of small groups may well prove totally dysfunctional when transferred to a market context.

The moral qualities of a market order - as of any other constitutional order - cannot be judged appropriately just by applying the moral instincts or intuitions referred to above. They should be judged according to whether their defining rules correspond to the (informed) consensual constitutional interests of the persons concerned. In other words, responsible moral criticism of the market system should prove its case by explicitly stating which of the rules of a market order are supposedly in conflict with the consensual, constitutional interests of the people concerned, and by specifying which alternative rules of the game are supposed to serve these interests better than the rules that are considered deficient.

Since Adam Smith's days, advocates of the competitive market order have, explicitly or implicitly, argued their case from the conviction that the order they favor serves the common interests of all, that it corresponds - in the terminology used here - to people's consensual constitutional interests. In his critique of the mercantilist system of privileges and in his appeal for what he termed the "simple system of natural liberty" Adam Smith was clearly concerned with the ethical nature of the competitive market order as a privi-

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8 This fact about our "moral instincts" has been stressed by F.A. HAYEK (e.g. 1979, p. 160, p. 164). Hayek's argument finds support in more recent contributions from "evolutionary psychology," such as J. TOOBY AND L. COSMIDES (1992).

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lege-free system, a concern which has been restated most emphatically by Franz Böhm, co-founder of the Freiburg School, in an article on "Private law society and the market economy" (1966). Yet, the message of the ethical value of the competitive market order as a privilege-free system has almost been drowned out by the choir of voices of those who, even if they are prepared to concede the "economic efficiency" of the market economy, nevertheless suggest that it is somehow a morally deficient system. In reference to such "resentment against economic liberty," as it emerged in the final decades of the 19th century, Franz Böhm (1980, p. 260) noted: "It was less the socialist critique than various diverse intellectual trends which have rapidly gained ground within the sciences - including economics - since the turn of the century that reinforced this prejudice: the conviction that the free market was an ethically reprehensible and socially amoral system gradually became an almost universally shared view among all intellectuals."

A preferred target of moral criticism is the link between market competition and profit-seeking, or, more precisely, the fact that the sanctioning mechanism of competition forces market participants to be guided in their economic decisions by anticipated profits. There can, of course, be no doubt about the fact that economic profit is the principal indicator of success in the "game of catallaxy," as Hayek has called the market exchange game. The "market game" works to reward those who succeed in producing goods or services for which others are willing to pay a price that exceeds the costs of providing them, i.e. the opportunity costs of the resources used. Profits simply constitute the difference between revenue and (opportunity-) costs. Profit-seeking thus means nothing other than striving for success in the "market game." If this is the case, what sense does it make to view striving for profit as immoral? What sense is there in reproaching the participants in a competitive game for simply attempting to play the game well? To be sure, one may well ask whether the game itself is desirable, i.e. whether it is at all in the common interest of all participants to play the game in its current form, i.e. as defined by the set rules, or whether they might not be better off playing a different game, one defined by better rules? Yet, if there is no reason to doubt that the game itself is a desirable game, then it is absurd to morally criticize people for seeking to play the game successfully, as long as they do so within the rules. And, if there are reasons to believe that a better game could be played, then the appropriate response is to seek a change in the rules of the game, not to require the players to disregard their own interests.

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What is true for other games applies, of course, no less to the "market game," namely that players, or market participants, are morally obliged to comply with the rules that are binding for all. Market competition does not take place in an anarchic vacuum; it operates within specific rules of the game, within the constitutional framework of a competitive order, a *Wettbewerbsordnung*. The participants are not at liberty to strive for success using any means available. They are expected to seek success only by employing means and strategies that comply with the rules of the game, rules which may include, in addition to what is explicitly codified and formally sanctioned, certain generally accepted standards of fair and honorable behavior, which, even if they are not sanctioned formally, one cannot violate without damaging one's reputation. However, it does not make sense to regard not only unfair striving for success, but the striving for success per se as morally suspect. Nor does it make sense to require market participants to compensate for deficiencies in the rules of the game by sacrificing their ambition to play the "market game" successfully. Ensuring that the competitive market process is a worthwhile and desirable game for all, as long as it is actually played according to the rules, is a matter of appropriate constitutional framing, the task of *Ordnungspolitik* or constitutional politics. To play the game within the rules is the obligation of the players. But it cannot be their role, to compensate, by their way of playing the game, for what *Ordnungspolitik* fails to do. Nor could they ever succeed in doing so.

### VI. Consensus and the Choice of Rules

If we assume that the attribute "moral" applies to rules which are in the *consensual* constitutional interests of the parties concerned, and if, on the other hand, we take into account that people generally have incentives to pursue their respective interests in *privileges*, a critical question arises with regard to the processes by which rules are selected. The question is whether conditions exist, or whether one can create or promote such conditions, in which people's consensual constitutional interests are likely to prevail (line 3, column 3 of the table). The remainder of this paper is about this issue.

Where people are in a position to affect the choice of rules in a community without regard for the interests of other parties, they will be tempted to opt for rules that put them in a privileged position, i.e. for rules that work to

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their differential advantage. Similar to what Eucken and Böhm had to say in their critique of what they described as "refeudalisation,"<sup>9</sup> the economic theory of rent-seeking (Buchanan et al. 1980) has pointed to the problem that, by their simultaneous efforts to secure privileges for themselves, people tend to bring about, as an unintended but inevitable aggregate outcome, an overall constitutional regime that is less desirable for all parties - including the "beneficiaries" of privileges - than a privilege-free rule system would be that reflects the consensual constitutional interests of all. Therefore, the vital issue is how a constitutional order that serves the consensual interests of all can be established, and how it can be protected from being eroded by privilege-seeking or rent-seeking activities that induce a progressive decline towards a system which, in the end, serves nobody's interests.

If the aim is to structure or frame the process of constitutional choice in ways that allow the consensual constitutional interests of the members of a community to prevail, and to "filter out" interests in privileges as far as possible, two basic approaches can be adopted. On the one hand, we can attempt to create conditions that *motivate* individuals to demand "fair" or consensual rules. On the other hand, we can attempt to create conditions which leave people with *no other choice* than to opt for consensual rule systems, i.e. conditions which exclude or at least effectively curb opportunities for successful privilege-seeking.

The first alternative is the theme of approaches that model the agreement on rules as a choice behind a veil of uncertainty (Buchanan and Tullock 1962) or ignorance (Rawls 1971). The essence of this concept is that people will be led, from their own self-interest, to choose fair or consensual rules, if they are ignorant or sufficiently uncertain about how alternative rules will affect them personally. Under such conditions, they need to consider the various possible ways in which they might be affected by the rules in question. Since they cannot know what their own position will be, they will have to assess the merits of alternative rules in terms of their predictable *general* working properties, i.e. in terms of how desirable they are irrespective of what one's particular position is. Stated differently, the effect of the veil of uncertainty or ignorance is to transform potential *inter*-personal conflicts of interest into *intra*-personal conflicts, causing individuals to opt for "unbiased" or fair rules out of self-interest. For the framing or structuring of constitutional choice processes this implies: To the extent that these processes can

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9 See VANBERG (1997a, pp. 716f.; 1998a, pp. 177f.).

be organized in ways that increase uncertainty about how one will be personally affected by the rules under consideration, the incentives for privilege-seeking will be lessened, and the prospects will be enhanced for consensual constitutional interests to prevail.

As regards the second alternative, two basic methods can in turn be distinguished by which opportunities for successful privilege-seeking may be reduced. The first method is to explicitly constrain legislative processes by a non-discrimination or equal-treatment requirement, i.e. to exclude discriminatory and privilege-granting rules as inadmissible. This has been the purpose of the classical principle of the rule of law, or the generality principle, as the constitutional ideal of what Franz Böhm (1980) has called the "private or civil law society."<sup>10</sup> Yet, efforts to implement this ideal by explicit constitutional constraints on governments and legislative powers have only had limited success. Especially in the area of economic legislation, all kinds of privileges have been, and are, commonly granted by governments and legislators of all modern democracies, be it in the form of subsidies, protectionist regulations, tax exemptions or other special treatments.

The second strategy for restricting privilege-seeking and improving the prospects for consensual constitutional orders consists of promoting competition between political communities or "jurisdictions." What constitutes a privilege for one party (e.g. the recipient of subsidies) has as its mirror-image a discriminating, differential burden imposed on other parties (e.g. as taxpayers or consumers). The easier it is for members of a jurisdiction to evade discriminating treatment by moving mobile resources or by migrating in person to an alternative jurisdiction, the narrower the scope for successful privilege-seeking and for sustaining existing privileges becomes. In the limiting case of cost-free mobility between jurisdictions, the only constitutional regimes that can be sustained will be those that command the voluntary cooperation of all parties involved.<sup>11</sup> Under such conditions, attempts at privilege-seeking cannot be assured long-term success. Whatever their respective potential interests in privileges might be, in the absence of willing counterparts who would have to carry the burden of their privileges, individuals will

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10 J.M. BUCHANAN AND R.D. CONGLETON (1998) provide a detailed discussion of the generality principle from a constitutional economics perspective.

11 This purely theoretical limiting case corresponds to what R. NOZICK (1974, pp. 297ff.) describes as a "framework for utopia," a meta-constitution which is to ensure that "each community must win and hold the voluntary adherence of its members" (*ibid.*, p. 316).

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have no other option than to choose among consensual constitutional regimes. Real-life conditions are, of course, far removed from this theoretical borderline case, but every change in technology, institutional structure or other relevant factors that facilitates mobility between jurisdictions makes it more difficult to gain and to sustain privileges, and it improves the prospects for consensual constitutional interests to prevail. The developments currently being discussed widely under such headings as globalization and jurisdictional competition may turn out to be more effective in implementing the classical liberal ideal of a privilege-free constitutional order than the traditional efforts at implementing the generality principle have been.

Of course, what applies to competition in general, is no less true at the level of competition between jurisdictions, namely, that in order for competition to work beneficially it has to be governed by appropriate rules. To address this issue is a challenge for the theory and politics of constitutional order.

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## **30 Contingencies, the Limits of Systems, and the Morality of the Market**

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- I. Contingency
- II. Coping with Grand Contingencies
- III. The Limits of Systems
- IV. The Morality of the Market

Contingency matters. Most determinants of our existence are neither the result of our deliberate choices nor the result of necessary laws of nature but are contingent. The facts of birth like the historical age, the generation, the place, the religion, and the family are contingent as well as are the facts of our fate, talent, health, life expectancy. Most traits of the person and of the economic and social institutions the person lives in are contingent in the sense that they could also easily have turned out to be different. Contingency is a basic attribute of human existence and society. It is, so the thesis of this paper, also the basic argument for the market. The market is seen here as the institution processing contingency and supporting societies to be able to transform contingency into realized chances and to expand the satisfaction possibility frontier of the individuals as much as possible. In terms of Leibnizian philosophy, the market realizes the maximum of compossibility of existence of humans, the maximum of human existence that can exist together at one point in space and time.

It is this feature of the market economy that is its final moral and economic justification. The unique ability of the market to cope with contingency is its justification and legitimation since the problem of the coordination of economic action is the central problem of the economy and the coordination device that manages the coordination best must be given preference. Since the market is able to make use of positive contingencies it generates the best outcome for the coordination problem. There is no other institution of coordination thinkable that could manage better the contingency problem.

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There is no mechanism of economic coordination thinkable that could come close in managing the coordination problem to the market. The reason for the uniqueness of the market in the ability to coordinate the economy is the problem of contingency.

### I. Contingency

Contingency is first a concept of logics. Logics distinguishes between contingent and necessary statements – not between contingent and necessary facts. Contingent statements are contingently true like empirical statements since their opposite is not necessarily wrong. Necessary statements are necessarily true like logical conclusions and the like since their opposite is necessarily wrong.

The term contingency describes, however, also real events and can be used as an ontological attribute of events and as a statement about a realm of being of reality. It then describes the way in which a part of reality is given, whether it is characterized by necessary relations or by possible or contingent relations. As ontological modality, contingency characterizes everything that could also be different from itself or different in its relations to others, everything that is not in a necessary relation with others. In this ontological sense, contingency is used in this paper. Laws of nature constitute necessary relations. It is, however, uncertain whether laws of nature are themselves necessary or contingent. It is an open question whether laws of nature are necessarily how and what they are or whether they have arisen contingently by a process of evolution that is itself contingent and whether the laws of nature are therefore in themselves also contingent.

The concept of contingent attributes or events goes back to Aristotle who gives an interesting example for a contingent event. He says that if someone goes to the market and meets someone else who wants to buy his merchandise this event is contingent or even accidental. It is accidental because it could also not have happened. The seller has met the buyer accidentally. Aristotle defines the contingent as follows: "It can be the case that something is possible to be but is not, and that something is possible not to be and, nevertheless, is."<sup>1</sup> The contingent event is even less possible than the possible

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1 ARISTOTLE: *Metaphysics* IX, 3,1047 a 20-26.

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event although it is possible that it occurs. The possible occurs normally but the contingent occurs even when it is possible not to be or likely not to be. The possible is, according to Leibniz, a continuum. It reaches from the contingent to the real. Contingent events are all events that could also not happen.

Contingent events can be distinguished in three classes, in events that happen by chance and luck, events that happen by free choice, and events that happen most of the time or are influenced but are not determined completely by laws of nature. Contingent events are either accidental, caused by chance and luck, or they are the result of freedom and free choice which means that the choosing person could also have chosen differently and that the results of his or her acts are, therefore, contingent. Or contingent events are the result of the coincidence of forces of general laws of nature or of statistical frequencies with other general laws of nature and statistical frequency.

This broad concept of contingent events comprises the accidental and the lucky event, the event as result of free and rational choice, and the event which depends on or is incidental to another event without being the necessary consequence of something else. Contingencies are either accidental or contingent on other events like coincidences of different lines of events that could or could not have happened and are neither accidental nor necessary. The contingent comes about by the coming together of other events.<sup>2</sup>

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2 Thomas Aquinas distinguished in his interpretation of Aristotle's *De interpretatione* three kinds of contingent events: first rare events (*ut in paucioribus*) which are grounded in accident and chance (*a casu vel fortuna*), secondly what relates in the same way to both options (*ad utrumlibet*) and is caused therefore by free choice (*ex electione*), and thirdly what happens in most cases (*ut in pluribus*) and is caused by nature (*ex natura*). Cf. THOMAS AQUINAS: *In libros Peri Hermeneias Expositio*, I, 13, editio Leonina, vol. I, Roma, Paris 1889, p. 67f. (l. 164-173):

"Ex hoc ergo concludit ultenius quod omnia sint de necessitate.

Per quod *triplex genus contingentium* excluditur:

quaedam enim contingunt *in paucioribus*, quae accidunt *a casu vel fortuna*;

quaedam vero se habent ad utrumlibet, quia scilicet non magis se habent ad unam partem quam ad aliam (*ista procedunt ex electione*);

quaedam vero eveniunt *ut in pluribus*, sicut hominem in senectute canescere, quia causantur *ex natura*."

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The attribute of contingency is a composite. It comprises the accidental and lucky, the result of free will and free and rational choice, and the incidental, the event that comes about by the incidence with other events.

This composite of luck, free choice, and incidence is exactly what qualifies the most events in the market and the differences between success and failure in the market. Market success is not only the consequence of free will and of free and rational choice since someone might have chosen the right option but incidentally other events that came together outside of his reach disturb his plan and bring about an adverse effect. On the other hand, someone might not have chosen very well, but luck and contingent developments make his choice to turn out useful and profitable and bring about a profit far beyond what would have been yielded to his decision under "normal" circumstances.

Entrepreneurial action in the market is neither action under certainty nor action under uncertainty. It is action under contingency. Its results are neither certain since if they were certain we could use a mathematical calculus for entrepreneurial decisions and there were no need for profit as a reward for risk taking, nor are the results of entrepreneurial action completely uncertain in which case any far reaching entrepreneurial strategy or long-term corporate planning would be impossible. Entrepreneurial action is about choosing strategies in an environment in which likely outcomes of rational choice, newly developing chances, good or bad luck and incidental developments work together to create a decision-making situation that is best described as being situated in a continuum that reaches from the uncertain, the contingent, and the possible to the certain outcome.

At the origin of the term "risk" is the concept of the danger of pecuniary loss in merchant trade.<sup>3</sup> Risk is the danger of not succeeding, of failure, default and going astray. Risk implies the possibility to take the wrong decision with the consequence of damage and loss. Risk is, therefore, not a good but a bad. It is the duty of the responsible person to minimize risk in order to minimize the occurrence of wrong decisions. Risk is caused by the uncertainty about the future. Uncertainty is the expression for the human situation of incomplete information.

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3 Cf. O. RAMMSTEDT: Article "Risiko", in: J. RITTER, K. GRÜNDER (Eds.): *Historisches Wörterbuch der Philosophie*, Darmstadt (Wissenschaftliche Buchgesellschaft) 1992, Vol. 8, col. 1049.

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Tracing the cause of risk back to the incompleteness of information is, however, insufficient since it implies that risk would vanish if information were complete. This is, however, not the case since information about the future will always be incomplete since the future is not deterministically caused by the past and the present. The information about the future is always incomplete since the world is no deterministic system but characterized by contingency. Contingency as good and bad luck, as the consequence of free will decisions, and as the consequence of the coincidence of different lines of causation is the ontological reason why the human knowledge about the future will always be incomplete. A world without risk is impossible since a world without contingency does not exist. It is the duty of responsibility to reduce risk to the good utmost and to make use of the "good" contingencies of luck and happy coincidence that accompany the "bad" contingencies of bad luck and detrimental coincidence.

Contingency is the more comprehensive term that comprises good opportunities and bad risks in one term. The morality of the market stems from its ability to make use of good contingencies and to reduce the influence and transform the bad contingencies of risk. The market is the societal form of coordination that maximizes the use of the good contingencies and tames the danger of the bad contingencies or risks of the economic process.

Frank Knight has contended that all property rights on resources, whether labour (human capital) or capital in general arise from three sources: effort, inheritance, and luck.<sup>4</sup> Wealth is the result of effort, inheritance, and luck. Inheritance, however, is also the result of effort, inheritance, and luck. So contingency iterates itself. On the side of the acting person, wealth results from efforts which include free and rational choice as well as work, inheritance, and luck. Effort and luck are, however, contingent on the right choice and on intelligence as well as on the right incidences of the acting person's strategy and anticipation of results with events outside of his control. The right incidences imply that a person's strategy fits with the contingent events that come up in the business environment, with the development of consumer demand and the development of the competitors' strategies which are neither certain nor uncertain but contingent for the business firm.

That the business environment is neither certain nor uncertain but contingent creates the possibility for entrepreneurs to anticipate the future and to be

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4 F. H. KNIGHT: *The Ethics of Competition and Other Essays* (1935), Reprint Freeport (Books for Libraries Press) 1969, p. 506.

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rewarded with profit for the right anticipation and to be punished by losses for the wrong anticipation. Both, profits and losses, occur since the future is neither certain nor uncertain but contingent and possible. The contingency of the future, *contingentia futura*, is the precondition for rational action since in an environment and in an economic development which would be completely random, no rational foresight and planning would be viable since the future would countervail every possible planning option. The future is also not deterministically or statistically certain since good and bad luck and incidental developments, positive and negative side-effects of managerial and entrepreneurial actions occur.<sup>5</sup>

The particular character of the business environment as being contingent implies that the radical subjectivism of the Austrian School of Economics must be modified. The evaluation of strategies, of cost and utility, are subjective but not completely subjective since humans usually tend to agree at least partly in their assessment of what is cost and disutility. The evaluation of types of actions and their outcomes are not subjective per se since we can classify types or kinds of actions. The evaluation of actions becomes, however, highly subjective if the incidence of outcomes of actions with the contingent events that happened to these actions and outcomes are evaluated and the mutual effects of actions and incidences are assessed by different subjects or decision-makers. Economic actions and strategies become subjective in the sense that they completely depend on the choosing subjects since the choosing subject must anticipate in his or her choices the contingent co-effectiveness of luck, good or bad luck, and of the incidences of a person's actions with other lines of events which have their origin either in the natural environment or in the actions of others. The incidence of a business strategy with the lines of strategy of the other competitors makes economic decision-making as well contingent as subjective.

The contingency of the events around our decisions and the contingency of the coincidence of our strategy with the strategies of others causes the paradox of choice that G.L.S. Shackle has introduced.<sup>6</sup> If our choice is effec-

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5 In P. KOSLOWSKI: *Prinzipien der Ethischen Ökonomie*, Tübingen (Mohr Siebeck) 1988, 2<sup>nd</sup> ed. 1994 (English translation: *Principles of Ethical Economy*, Dordrecht, Boston, London (Kluwer Academic Publishers) 2000), I developed a theory of entrepreneurial action which describes entrepreneurial action as an action that maximizes the positive side effects of the firm's actions on the environment and within the firm.

6 On the paradox of choice, cf. G.L.S. SHACKLE: *Imagination and the Nature of Choice*, Edinburgh (Edinburgh University Press) 1979, p.19.



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tive we cannot know what will be the final effects of our decision resulting from an act of choice. Since the decision will alter the course of the world we cannot assume that the world will continue the current course it took up to this date. We cannot extrapolate the future from the past development and line of events. If, on the other hand, we already precisely know before our actions the future course of the world including the effects our actions will have on it, the future course of events is beyond our influence, and our decision and choices are without significance. We have then no real choice.

The power of choice and the extent of the contingency of the future co-determine the effect of our choices. If the power of our decision-making is high but the contingency of the future low our choices have little impact. If the contingency of the future is high little decision-making power will make a great impact if it coincides with the right contingent developments. The reach of our decisions and of our subjectivity is determined by two variables, by our power of choice and by the contingency of the future of the environment of our actions.

The paradox of choice is rendered less paradoxical by the fact that the world seems to be also suitable for human action since the world allows for contingency in the sense of incidental developments. The power of choice is not reduced but increased by phenomena of the contingent future co-effectiveness of events. If the world only continued to run as it used to do or if it completely changed its course due to our actions no real choice and rational foresight would be possible. Shackle's paradox of choice would be prohibitive for any kind of far-reaching decision-making. That the world is neither completely continued nor completely changed in its course by our actions, is due to the contingency of the effects of our actions with other courses and events in the world. Human action is able to be co-effective or incidental with other events and lines of events. It is neither necessarily effective for a future event and certain in its effect nor completely ineffective and uncertain in its results.

From this line of thought follows that the market is not only necessary because of the subjective nature of cost that cannot be anticipated by a central planning agency as Hayek has shown. The market is necessary for the coping with contingency or for the subjective nature of using possibilities of positive contingency or positive side-effects and incidental developments. The subjective nature of cost can be questioned by the intersubjective agreement on what are disutilities. The necessity to decentralize the economic decision-making rather follows from the fact that positive contingencies can only be

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perceived and be made use of by subjects, by economic agents, that take advantage from the positive contingencies at one locus in time and in space. These contingencies which are linked to local space and local time cannot be perceived by a central decision-making agency.

The argument from the positive contingency of economic actions with the incidences of other lines of events resembles Hayek's argument about the dispersion of knowledge in the economy by the market but it stresses the ontological aspect of this localized knowledge of contingencies, not so much the subjective aspect of it only. The positive contingencies of economic action rise at and are perceived by the economic subjects and their co-subjects. They cannot be perceived by a central planning agency since a central planning agency cannot be local everywhere, it cannot be at every place where the contingent economic interdependencies and incidences of luck, free and rational choice, and incidental co-developments occur.

### **II. Coping with Grand Contingencies**

Successful strategies in the market, i.e. the right entrepreneurial choices and the right incidences with other events in the business environment as well as positive contingencies, usually do not pose any difficulties. They are rewarded by profits. Limited negative contingencies and wrong strategies will also be coped by the market by losses or even bankruptcy. Bankruptcy leads to the reallocation of resources and, therefore, even to an increase of economic efficiency.

The problem for a society are not the normal negative contingencies and failed strategies of the market but the contingencies that cannot be easily made up for by market reallocation. There is a class of radical contingencies like chronic disease, old age poverty, unemployment due to structural crises of the economy or due to historical catastrophe like state bankruptcy, break down of an economic system, or war, or due to enormous historical changes like a sudden globalization of the economy which do not fit into the kind of contingencies the market can cope with by factor reallocation. Societies have to cope with these contingencies even if the market is not able to do so or not able to do so sufficiently. It is not so much a discussion of market failure but of market sufficiency or market insufficiency that matters in cases of this "grand contingencies".

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The questions about the sufficiency of the market in coping with the radical contingencies arise typically not with the normal but with the extreme risks and contingencies. Take the insurance against disease, unemployment, old age. There is a market for insuring the normal risks in the contingencies of human life that works sufficiently. There are, however, some risks private insurances do not like and usually do not accept to insure: chronic disease, a duration of retirement longer than assumed by the life insurances due to radically increased general life expectancy, and structural unemployment of entire regions or nations. Accordingly, crowding-out of bad risks from the insurance market questions the ability of the market to cope with "grand contingencies".

The response of the classical German economic tradition of the Historical School has been since the 1880s that a minimum social insurance against these contingencies should be institutionalized and funded by the government on a national scale beside the still continuing market for private insurances.<sup>7</sup> The Bismarckian argument was that the industrial economy creates such new and high risks for the industrial workers that the insurances of the market could not provide insurance for all workers at sufficiently low cost. Later, this system of social insurance was extended beyond the basic or minimal social insurance to a maximalist social insurance system. One extension took place after World War II to provide old age pensions for those who had lost all their property in the war either by war destruction or by the mass expulsion of 10 million persons from the East German Lands.

The example of the German social insurance for old age pensions demonstrates the classical ratchet-effect problem the social insurance faces: If social insurance provisions are extended due to "grand contingencies" it is usually politically almost impossible to reduce them again to the pre-contingency level after the contingency ceases to prevail. This ratchet-effect also explains why it is difficult to make the necessary cut-backs in the social insurance of the German social state today – in contrast to the American policy on this issue in the years 1980s.

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7 Cf. PETER KOSLOWSKI (Ed.): *The Theory of Ethical Economy in the Historical School*, Berlin, New York, Tokyo (Springer) 1995; PETER KOSLOWSKI, ANDREAS FØLLESDAL (Eds.): *Restructuring the Welfare State. Theory and Reform of Social Policy*, Berlin, New York, Tokyo (Springer) 1997; and PETER KOSLOWSKI (Ed.): *The Social Market Economy. Theory and Ethics of the Economic Order*, Berlin, New York, Tokyo (Springer) 1998 (= Studies in Economic Ethics and Philosophy).

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The nature of grand contingencies and the ethical principle of the golden rule give legitimacy to a social insurance of grand contingencies and "bad risks" – but only to a minimal social insurance scheme. Kant argued that such a scheme is postulated by the categorical imperative or universalization argument since everyone expects to receive some minimal support if he or she happens to be in severe need and is in turn prepared to support a social insurance scheme that finances such a support to others when they are in need. Kant also stated, however, that every social insurance scheme that would go beyond a minimal social insurance would be illegitimate since it compels the other to a contribution that is not grounded in and supported by the universalization principle. The beneficiary of social insurance cannot be thought of agreeing in turn to pay for a maximalist insurance scheme.

It might be difficult to determine in detail at which degree of risk coverage for a population a minimal social insurance scheme should end. There is, however, an economic and moral argument for the universalization of an insurance scheme against "grand contingencies" and at a minimum level, an argument taken from the structure of contingency and the ability of the market to cope with these serious contingencies. The argument for a minimal social insurance is a liberal argument for a minimal social state, not just for a minimal state.<sup>8</sup> The idea that the state should be only a state of the rule of law (*Rechtsstaat*) is not sufficient for the grand or historical contingencies that might hit a society or community of societies. This minimal social state is still a "protective state" in the James Buchanan's terminology, not a "productive state". The state of the rule of law, by the nature of contingency, must be complemented by the idea of a "minimal social state". The argument for a minimal, and only a minimal, social state is derived from the nature of contingency and the need of the institutions of society, market and state, to stand in for each other. The need of coping with contingency renders it impossible to have a monistic social system that is either only a market system or only a centrally governed state system. A monistic, centrally directed economy is unable to use the positive contingencies of economic action, a monistic market system cannot sufficiently manage the great contingencies and bad risks of a society. This impossibility of a monistic system describes at the same

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8 F. A. VON HAYEK: *The Constitution of Liberty*, London (Routledge) 1960, Reprint 1993, p. 101, points to the fact that the idea of a common insurance against certain risks is very different from the idea of a redistributing welfare state that redistributes "welfare".

time the limits of systems thinking in economic, constitutional, and political theory. The contingent blows up the closedness of systems. Grand historical contingencies can test the ability of the market to cope with contingency to its limit.

One example for such a test of the market's ability to cope with historical change is the present globalization of markets. The theory of free trade and of comparative advantages requires the integrated world market. The maximum gains from trade in the world market are harvested only if not only merchandise but also immediate inputs are traded in the global market. This leads to the outsourcing of low-skill labour from the industrialized to the developing countries with the effect of decreasing wages for unskilled labour in the rich economies.<sup>9</sup> For the unskilled labour force, this outsourcing of its labour to foreign countries is experienced as a serious contingency that might endanger its basis of subsistence if wage rates drop dramatically.

The market, however, is eager and should be eager to ripen the benefits from the international division of labour also on the level of intermediate inputs. If the economic and social contingencies experienced by the labour force caused by the globalization of markets threatens large strata of the population in their economic status political support for free trade will vain, and protectionism will find a majority vote.

Analysis from economic history shows that this happened in the time at the end of the free trade period and the rise of nationalism and protectionism in Europe at the beginning of the 20<sup>th</sup> century up to the rise of fascism and national socialism. It might, therefore, be necessary that free market supporters unless the free trade policy loses its political support by voters for open and globalized markets, subsidize the wages of those who are outsourced by the process of globalization. Feenstra discusses this possibility and states that "economic hardship due to trade liberalization will be treated differently from hardship due to changing domestic conditions."<sup>10</sup> He adds the question: "It is worth asking why workers and firms in trade-impact industries receive special compensation while individuals experiencing economic hardship for other reasons do not."<sup>11</sup>

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9 Cf. ROBERT C. FEENSTRA: "Integration of Trade and Disintegration of Production in a Global Economy", *Journal of Economic Perspectives*, 12 (1998), p. 34. Cf. also LAWRENCE H. SUMMERS: "Reflections on Managing Global Integration", *Journal of Economic Perspectives*, 13 (1999), pp. 3-18.

10 FEENSTRA, *ibid.*, p. 44.

11 *Ibid.*

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The answer to this question is twofold: For once, globalization of the grand scale with outsourcing of unskilled labour and whole industries is experienced as a "grand contingency" revolutionizing the market economy in the developed economies quite similar to the industrial revolution of the 19<sup>th</sup> century. Globalization might be the "social question" of the 21<sup>st</sup> century the same way the situation of the industrial worker in the process of the industrialization was the "social question" of the 19<sup>th</sup> century.

The other reason why economic hardships stemming from globalization and free trade are regarded to be different from hardships caused by changing domestic economic conditions is that globalization is not experienced as a contingent or necessary development outside of political control by a nation but as the political-economic option to open the national market or not to open it. This perception of the economic reality might not be true for export-dependent countries like Germany but it might be the politically effective perception of economic reality. Voters who object the "political option for free trade" ask for compensation for accepting to be overruled by those who are convinced that the opening of markets is necessary and economically advantageous.

Although globalization is a necessary condition for a working world market and for the increasing wealth of the nations in the world it can be useful from a market standpoint to compensate those who loose by the secular contingency of globalization in order to secure their political support for free trade. This compensation is even a win-win situation if the winners of globalization give away less to the losers than they themselves gain from increased globalization and free trade. To sum up: The process of globalization can be interpreted as a grand historical contingency that puts at risk large groups in the economy so that their support for this very process can only be secured by the social state standing in for the market by compensating the losers in order to secure the conditions for the persistence of free trade and market process. The possibilities of strategic behaviour and rent-seeking on the side of the losers of globalization and of those outsourced by the global market still persist and require cautious observance by any government.

### III. The Limits of Systems

The contingent and unforeseeable contradicts by definition the systematic. Systems find their limits where that happens for which they are not prepared, the contingent and unsystematic. This is most obvious for the historical change of a grand scale like the break-down of empires like Communism in Eastern Europe. The system that broke down, the system of Marxism-Leninism, was not prepared to break down, and the system who followed it, the market, was also not prepared to take over. The transition formed therefore a problem not only to the Marxist system broken down but also to the thinking in economic systems of liberalism since there was no "system of transformation" available, no systematic theory of the transformation from Communism to the market economy.

The conviction that the market is superior has, therefore, often concealed the awareness of the fact that a newly institutionalized market cannot cope with the mass of contingencies that are produced by such an enormous historical transition: mass unemployment without any social security. An example is the Russian firm: Russian firms between 1996 and 1998 did either pay no wages at all or only half of the promised wage rate to their workers. The workers nevertheless did not leave the firms, a fact and behaviour that is completely inexplicable by normal market theory. Although the workers were not paid they did not leave the firms because there existed no employment alternative with other firms and no social security payments. There happened no immediate efficient reallocation to overcome the contingency of unemployment since the creation of new employment by factor reallocation was hindered by other factors in the institutional framework of the market. A similar development took place in the Chinese "Socialist Market Economy".<sup>12</sup> The Chinese economic reformer refused to close bankrupt state owned firms with the argument that there is no alternative employment for the workers of these firms and no state insurance available so that the firms cannot just be closed although economically it would be desirable to impose hard constraints like strict bankruptcy laws on these firms. Social insurance as a means to cushion historical contingency was neither available in China

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12 Cf. P. KOSLOWSKI, Y. CHEN (Eds.): *Sozialistische Marktwirtschaft - Soziale Marktwirtschaft. Theorie und Ethik der Wirtschaftsordnung in China und Deutschland*, Heidelberg (Physica) 1996.

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nor in Russia. The introduction of an uncushioned labour market in the transition process to the market economy delayed in Russia and apparently also in the Czech Republic the acceptance of the market as an institution coping with the unavoidable and even useful economic contingencies of a normal scale.

The argument that the market as the economic order of a free society cannot be thought of adequately as a monistic system can be given in several versions and from different approaches. The first theory emphasizes the necessary distinction between society and state against the idea of a monistic market society. The second approach, the theory of subsidiarity, contends that there is a necessary subsidiarity between the market and the state. The third approach, the theory of social systems, claims that social systems are systems of systems and not monistic systems. The fourth approach stresses the epistemic problem that it is impossible to think a total system without having already transcended the borders of the system in question.

The distinction of state and society developed since Hegel and Lorenz von Stein emphasizes the need of a higher order central institution of observation, analysis, and counterbalancing action that "sublates" developments of crises that occur in the economy and in society.<sup>13</sup> The legislator and the executive government are seen as institutions correcting contingent developments of the market and of society and helping the development of the market and civil society. The state and the government are seen here as a limitation of the system of the market. The market, however, is not conceptualized as a limitation of the system of the state. This forms severe weakness of the Hegelian model of the "sublation" (*Aufhebung*) of civil society and the market by the state that questions the value of the theory. The Hegelian tradition only considers the case of market failure and its sublation by the state, not however the case of government failure and its compensation by the market or civil society.

The theory of subsidiarity overcomes this model of the sublation of the market by the state by introducing the principle that the institutions of state, society, and economy are not ordered by the principle of linear sublation but by the principle of coordination and subsidiarity. The subsidiarity principle contends that the basic principle for the actions of all social institutions or subsystems is the principle of mutual support or auxiliaryity. The relationship

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13 Cf. PETER KOSLOWSKI: *Gesellschaft und Staat. Ein unvermeidlicher Dualismus*, Stuttgart (Klett-Cotta) 1982.



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of the societal institutions family, market, state, is not one of mutual sublation but of subsidiarity. They must stand in for each other when one of them fails or is insufficient. The subsidiarity principle comprises the auxiliary principle of mutual support and the compensation principle of standing in for each other in the case of failures of the societal institutions. Within the structure of government and administration, the institutions of the state must support each other and secure that the different branches of government can fulfil their task and stand in for each other. Between the market and government, governmental institutions must stand in for private enterprises if the market is insufficient. In turn also firms must stand in for the state according to the subsidiarity principle if government failure occurs because it is not the case that only the state compensates market failure, but also required that the market compensates government failure. The subsidiarity between government and business firms requires that not only the state but also firms must feel responsible for reducing long-term unemployment and to help the state in reducing the costs of social insurance.

The subsidiarity principle as a principle of auxiliary and of compensation for failure is also expressed from a different starting point and theoretical approach in the system theory of sociology. It is an irony that system theory, in one respect, makes the social scientist aware of the limits of system-thinking in the social sciences by pointing to the multiplicity of societal subsystems. Niklas Luhmann defines society as complex social contingency in which the subsystems must be open for the contingencies the other subsystems produce. "Society is at once extremely complex social contingency and selective, for example normative, structure."<sup>14</sup>

Modern societies and economies are characterized by an enormous extension of that which could also be different and is therefore contingent. They are not determined by natural, but by normative restrictions and by the degree as to which they can process the contingencies that occur in societal subsystems by standing in for other subsystems. This mutual support of subsystems presupposes that the subsystems like the market and government are open for each other and stand in for each other in cases of crises. System theory shows that neither society as a whole nor the system of the market can be thought of as a closed system. The idea that subsystems could form self-sufficient and

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14 NIKLAS LUHMANN: "Gesellschaft", in: NIKLAS LUHMANN: *Soziologische Aufklärung. Aufsätze zur Theorie sozialer Systeme*, Bd. 1, Opladen (Westdeutscher Verlag) 1970, 4<sup>th</sup> ed. 1974, p. 145.

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closed systems or that the market could be a closed monistic system is as inadequate as the idea that society as a whole is one closed system.

The limitations of system thinking point to the fact that economics as a science is linked to the modern idea brought up by the system philosophy of German idealism that knowledge forms one system of totality or one systematic totality. The German economist Pesch has pointed to the fact that the rise of economics as an autonomous science coincides with the rise of the grand philosophical systems in German idealism and with the system-building of philosophy. Economics as a system of thought and the idea of an economic order being an autonomous system are in danger to fall victim to the fallacy characteristic of "system-building": The construction of the system and the freedom to construct it or not to construct it are mistaken for the autonomy and self-sufficiency of the object of this system of knowledge, the economy or the state. The autonomy and self-sufficiency that characterizes the process of system-building in the mind of the thinker is taken to apply also to the reality of the system it is developed for. The same autonomy and self-sufficiency that the thinker experiences is also ascribed to the system he thinks about.<sup>15</sup>

This critique of system thinking in economics might not be applicable to the theory of market process in the Austrian tradition. It is, however, certainly applicable to the theory of a general equilibrium. General equilibrium theory conceptualizes the economy as an autonomous and self-sufficient system tending towards "general" equilibrium. The failure of system-building is also dominant in the Marxist philosophy which derived its systematic zeal from the Hegelian idea of a system of absolute knowledge. It seems to be one of the ironies of the transition process from the Marxist economy to the market economy in Russia that many of the Russian reformers just jumped from one system thinking to the other. They believed to be able to substitute the system of Marxist philosophy and communist planning by a similarly closed system of totally unregulated market and market equilibrium. In both approaches of system philosophy, the legal, moral, and cultural presuppositions of the market economy and the need for subsidiary social institutions supporting the market have not been considered.

Amongst the thinkers of system philosophy, Fichte and the late Schelling transcended these limitations of system thinking. Fichte came to the conclu-

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15 Cf. HEINRICH PESCH: *Ethik und Volkswirtschaft*, Freiburg im Breisgau (Herder) 1918, p. 126.

sion that a system can only be recognized as a whole when one has already transcended its borders and can see it from the outside. He further elaborated this insight to the idea that the absolute and the totality must be separated and the totality can only be thought properly if an external to it is thought and the absolute is distinguished from the totality. Schelling's self-critique in his very late philosophy comes to the conclusion that the historical, the factual and contingent historical facts, form the limitation of the rational construction of systems. This insight in the limits of rational systems led Schelling to the distinction between a system of purely rational philosophy which starts from the thinkable and a positive philosophy which tries to think the historical process of the world in its factualness.

This philosophical self-reflection and self-critique of the great system builders of philosophy can be applied to the problem of economic systems. The simple epistemic observation that we cannot think a system without having transcended its borders and without looking at it from the outside reminds us of the need to see also economic systems from their limits and from the line where the contingencies of the different institutions of society border on each other. Fichte's proposition that a border can only be recognized when we have already transgressed it can be transformed to mean that we can only recognize a system when we have already transcended the border of this system, an observation that is also true for understanding economic systems.

#### **IV. The Morality of the Market**

The morality of an economic system cannot be defined in terms of individual ethics only. The question which economic system is required by moral theory concerns the judgement as to the performance and goal-attainment of the economic system in question. The morality of the market must be decided by the criterium whether the market fulfills the task of the economy and the idea of the right (*Rechtsidee*). The idea of the right in the natural right tradition states that the moral obligation follows from the nature of the matter of an institution and that the purpose of an institution and the adequacy of its operations to this purpose form the core criteria as to whether an institution fulfills ethical or moral standards or not. Additional criteria beside the goal- or purpose attainment of an institution are the certainty of the law and the

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equality before the law. The certainty of the law ascertains the members of a law and ethical community that their expectations about future rules and future actions following these rules are fulfilled, that the stability of the behaviour and of the expectations concerning the behaviour of others are warranted by the legal and ethical code of the economy.

The moral criteria for economic systems are, therefore, that they must optimally fulfill the purpose of the economy, must ascertain stable expectations about the rules of the economy and secure the certainty of the law and of the moral code, and must finally warrant equality before the rules that govern the economic system.

The goal of the economy is to secure the wealth-creation of the nations of the world. Wealth-creation, however, presupposes the optimal use of the opportunities that rational choice, freedom of choice, and the contingencies of luck and of incidences with other actions offer. The economy has to be efficient. Efficiency is, however, not only the result of rational choice but also the result of creating new goods and new opportunities out of the contingencies of individual freedom, of luck, and of external incidences. The economic order must be such that it opens the space of opportunities for these fourfold conditions of efficiency, for rationality, freedom, luck, and incidental contingent developments. It is too limited to judge the performance of an economic order from the point of view of rational choice only. Rationality is only one aspect of the optimal use of the environment, of its contingencies and opportunities. Creativity, speed, imagination, courage, prudence, etc. are other virtues that are required by the economic process and should be furthered by the economic system. The contingent as the new, the free, and the lucky, requires a frame of mind that is not sufficiently described by "rationality". The contingent and the quality of mind required to cope with it transcend mere rationalism. The elements of contingency and freedom in the economic process require a frame of mind and a set of economic institutions that can cope with them and further the productive use of them.

The market is the only system that fulfills the criteria of being adequate to the purpose of the economy, to secure the certainty of institutional rules and expectations, and to realize equality before the rules. The adequacy of the market to the goal of wealth-creation is particularly secured by the market's unique ability to cope with the contingent – not with the rational only – as has been shown. The rational as a calculus could also be fulfilled by other devices than the market like central planning. The synergetic interplay of free and rational choice with the emerging contingent opportunities in time and

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space form the unique feature of the market that puts it at the same time above merely rational systems and constructions. The market is a network of interactions by which humans respond to planned and to contingent developments. The market is not a computing machine which processes fixed input information into fixed output information.

The market as a synergetic network of rationality, freedom, and contingency is more than a rationalist institution. Rather, it draws its resources for processing information and creating knowledge also from extra-rationalist, not irrationalist, human cognition and action. The market is in itself a critique of misplaced system-thinking and rationalism. The market processes rational choice and is at the same time a means to control the dominance of rational constructions. Against the illusions of central planning and against the constructions of systems of "general equilibrium" of the economy, the market is a form of the deconstruction of constructivistic economic systems.

It is not merely accidental that the critique of deconstructivism on the grand rationalist constructions of Marxism and Hegelianism preceded the real deconstruction of the construction of the Communist planned economy in the years 1980s in works like Jean-François Lyotard's *The Postmodern Knowledge*. The postmodern deconstructivism might have had its strongest point in the deconstruction of rationalist economic planning and less so in the deconstruction of all systems of culture.

The last ten years since the fall of the Berlin wall demonstrate that it is immoral to deprive humans of the opportunity to use the contingencies of the economy and of their personal life to their individual advantage. The constructivist attempt to ban the contingent from the social and economic realm deprives human individuals not only of possible wealth or of economic goods in the narrow sense but also of the opportunity to cope with the contingencies of the economy and of their personal life with freedom and dignity. The idea to liberate society from the contingent that inspired Communism and Socialism is in itself mistaken since the contingent cannot be expelled from the world of humans. Having the chance to cope with contingency on a personal level is not only a precondition of human freedom but also of human dignity. The idea to turn over all freedom and contingency to the state led to a society in which the individuals were not treated as persons with their subjectivity anymore but as objects and parts of a great machine that aimed at transforming their and all others' freedom and contingent features into illusions of "security".

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The contingent belongs to the human person. The contingent is at the same time accidental and incidental, *zufällig* and *zufallend*. An economic system that excludes the accidental and everything that falls into the hand of individuals by incident with other events reduces not only wealth but also freedom and personalness in a society. Behind the Socialist affect against the contingent and its resentment against economic freedom, the idea is effective that the contingent opportunities of the market are only zero-sum-games. The Socialist resentment claims that the positive contingencies that are used in the market by the capable and imaginative individual are taken from the others and reduce their opportunities and positive contingencies.

This argument must be unmasked as an expression of resentment, as resentment itself. Max Scheler described the nature of resentment as the attitude to deny not only that the resented person has an envied quality. Rather the resentment argues on a higher and more vicious level. It denies that the apparently positive quality the envied person undoubtedly demonstrates is a quality of excellence at all. The resentment claims that the excellence contended or exerted is in fact no desirable or excellent quality at all. In the case of the market the *ressentiment* declares that coping with contingency is no productive activity, that it reduces the opportunities of others, and that society would better do without it.

In reality, it is in the very nature of coping with contingency that it does not reduce the chances of the others to do the same. It is, of course, true that the opportunities used by one entrepreneur cannot be used by another person in the same way. But the opportunity originating from a contingency that the entrepreneur transformed into an opportunity was not there before it was recognized as such by someone. It could, therefore, not have been taken away from someone in the sense of a zero-sum-game because it was not there before it was created. Something that is still to be created by someone cannot be taken from someone else.

The open society is not a closed system but a space of opportunities and of the use of contingencies and of freedom. The open society is basically a market society although society and the market are not co-extensive. It is characteristic of an open and market society that the market's model of coping with contingency also influences the other societal subsystems of culture, science, and politics. This expansion of the paradigm of the market beyond the economic system is not market imperialism or "colonialization of the life world" (*Kolonialisierung der Lebenswelt*, Jürgen Habermas). It is not an indicator of crisis but of the growing attractiveness of the way the market

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cope with contingency. The processing of contingency by the market seems to have a higher rationality than other ways to cope with contingency in society like central planning or hierarchical institutions. One of the reasons is that the market acknowledges the freedom of the individuals and never completely overrules, as James Buchanan has shown<sup>16</sup>, an individual vote expressed by money demand or the "Dollarvote".

Despite its implicit critique of constructivist rationalism and despite the self-limitation of the power of constructivist reason, the market exerts a higher rationality than systems of constructivist rationalism.

Because of this unique ability of the market to cope with contingency, interventions into the market have the burden of proof to demonstrate that they handle a given historical or economic contingency better than the decentralized decision-making of the market. I have discussed some cases where the scale of the contingency might require such state intervention.<sup>17</sup> These "grand

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16 JAMES M. BUCHANAN: "Social Choice, Democracy, and Free Markets", *Journal of Political Economy*, 62 (1954), pp. 114-123, and JAMES M. BUCHANAN: "Individual Choice in Voting and the Market", *Journal of Political Economy*, 62 (1954), pp. 334-343.

17 The eminent role of religion to help humans to cope with the great contingencies of life, disease, death, sequence of generations, and loss of beloved ones, should also be noted here. HERMANN LÜBBE ("Vollendung der Säkularisierung – Ende der Religion?"), in: *Fortschritt als Orientierungsproblem. Aufklärung in der Gegenwart*, 1975,

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contingencies" that limit the reach of the market do not, however, refute the primacy of the market in coping with the normal contingencies of human existence and economic action.

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pp. 169-181, here p. 177) defined religion as the "practice of coping with contingency" (*Kontingenzbewältigungspraxis*). From the point of view of this theory of religion, important insights can be gained into the theory of the market. The deeper relationship in the matter between the centrality of contingency in the religions and in the market would deserve further study. It is undoubtful that the American society which allows for the greatest contingency of market success and market coordination is also one of the most religious societies in the world. At the same time, the idea in Lübbe's theory of religion which also characterizes the American version of the Christian religion that religion is the *individual* coping with grand contingencies – and not so much a collective one – points to the particularly Protestant tradition of individual religion.



## **Part VI**

# **Buchanan as Teacher and Colleague**

# **31 Mr. Buchanan - Some Episodes from the Life of a University of Virginia Graduate Student in the Early 1960s**

CHARLES R. PLOTT

- I. Public Finance
- II. Betty
- III. Ideas
- IV. Academic Exposure

## **I. Public Finance**

At the University of Virginia in the 1960s Public Finance was an upper level course taught by Mr. Buchanan. Everyone was referred to as "Mr." at the University of Virginia and the daily-required dress for classes was coat and tie. No student would have imagined calling Mr. Buchanan "Jim." I recall how the class was conducted. His style was to assign either papers or a topic for reading and students were required to produce written documents of no more than a page or two on each assignment. This ritual began the first week.

The first assignment was to produce a "positive case for tax reform." I think it was broad tax reform related to a paper that had been assigned for reading. The paper contained many opinions and value judgements and Mr. Buchanan had made it clear that preaching did not particularly impress him – and he equated preaching to the implicit use of value judgements in papers that were supposed to be based on facts. Of course, none of the students knew Mr. Buchanan beyond his formidable reputation, the reputation that had attracted me to the University of Virginia the preceding year. His classroom presence made it clear that assignments were to be taken seriously and that production of paper by the students was definitely expected.

I could see many approaches to the assigned problem. The paper we were using as a background could be ridiculed. One could use the opportunity to express personal opinions about various and sundry governmental tax poli-

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cies. I could search for inconsistencies in either the tax code, general tax policies or in the implicit value judgements in the assigned paper. However, the assignment used the word "positive" and none of the approaches I could imagine seemed to be responsive to the challenge that Mr. Buchanan had given to us. He had given no hints on how one might proceed.

My mind could produce only one conclusion. The assignment was impossible. It was based on a confused view about areas in which positive analysis could be applied. I could not see how a matter of active policy analysis promoting a change in policy could be approached without some sort of value judgement. On the one hand, I knew that Mr. Buchanan must know how to solve the problem or he would not have given the assignment. On the other hand, my mind could produce no answer other than the assignment could not be done. Faced with the fact that a paper must be produced I began to write.

Almost certain that my days at the University of Virginia were numbered, due to the fact that I was going to tell an established professor that he did not know what he was talking about, I nevertheless tried to make my case. Perhaps in the process of getting the boot I would learn something important. In many clumsy ways my essay said that value judgements were inherent in any such task. Listing every approach I could imagine, I tried to identify the point at which a value judgement was inescapable. My first and last sentences said that the task was impossible. As I prepared the paper I figured that a Ph.D. career for me was simply not in the cards.

I do not remember if we turned in the papers and then discussed them or discussed them and then turned them in. I do remember that the first reaction a student received from Mr. Buchanan was in the public forum of the classroom after ideas were exposed to the class and to Mr. Buchanan. Since this was the first part of the semester and the class had not yet experienced how Mr. Buchanan expressed displeasure, I did not know the form of execution that I would experience.

In a million years I would have never guessed what happened. Mr. Buchanan was ecstatic with my ideas and my work. He read my paper to the class saying that I was precisely right. He went over the other papers, exposing his own curiosity and the difficulty he was having dealing with this sort of question. With each student he pondered how the student might be able to get around my position. It was clear that mine was not an answer that he wanted and he felt that other alternatives must exist but, in fact, he shared my opinion. His grading practice was to assign either a minus or a plus to a paper as opposed to letter grades and I think that I received two of the latter. I was

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shocked and relieved but, more importantly, I was excited about the intellectual honesty that I was privileged to be a part of.

To me the lesson was profound and the lessons that I continued to get from the class were similarly profound. The lessons were not necessarily about public finance, although we learned that as well. Mr. Buchanan was instructing us in a process of discovery, by either posing a question because of its intrinsic interest, or as an attempt to extend the ideas of others after critical review. In fact, most of the assignments were to "criticize" and so ingrained became this process of criticism that for years later it was difficult to even read a paper without putting it down in disgust and listing objections.

Nevertheless, in this atmosphere of critical review, the ideas of others were held with respect. More importantly, the students learned that their ideas were treated just as seriously as those of the author of the paper in review. Mr. Buchanan readily admitted when he did not know something and was quick to acknowledge when a student's ideas were better than his own. This lesson was about the irreverent and dispassionate nature of research, with the arbitrator being logic and nature itself, and it influenced us all. No argument was won by appeal to authority. The ground rules for discussion resided only in facts and logic.

We all enjoyed the occasions when Mr. Buchanan assigned one of his own papers for review. The students would chew these up just as readily as any others without even bothering to be polite with the use of language. Mr. Buchanan would take the abuse with a smile and be particularly excited when someone could prove him wrong. The tougher the criticism the greater the praise. The training in the course was to take no prisoners - not even the professor!

It is interesting to contrast the class of Mr. Buchanan with the classes in the business school that were held jointly with law school students. I recall one discussion in particular when one of the economics graduate students, Admiral George Brown, was questioning the arguments advanced in the case the class was studying. "It is a clear example of collusion," argued a law student. "That does not follow from the facts and pattern of data," claimed Brown. "I don't care," replied the law student, "it is still an example of collusion." "Says who?" asked Brown in a tone of disbelief. The discussion was ended by the law student's appeal to authority: "Judge X, that's who!" In Mr. Buchanan's class the discussion would have never ended like that.

He demonstrated that intellectual activity is a process of discovery and all of us are part of it. He did not pretend to have the answers to all questions.

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He never hesitated to admit that he did not know. He was urging us to ask deep questions and to not avoid the philosophical. His own deep seated hope seemed to be that policy/political analysis without values is possible and that the problem just needed better elaboration. We would bump against this complex issue from time to time but the lesson seemed to be to skip problems that we could not solve and go to the next one. Get the ideas out. Push rather than repeat.

This free-for-all of ideas did not go unnoticed by the students. Several were upset because we were not using a famous book by Musgrave. Basically, they thought that we should be learning to repeat what others said. Of course, that was not to be.

### II. Betty

The formality of the Thomas Jefferson Center at the University of Virginia was shattered by the presence of Betty Tillman. All graduate students were (and remain) her "boys and girls." Mr. Buchanan, Mr. Coase, Mr. Nutter, Mr. Tullock and Mr. Yeager were all "Mister" but Betty Tillman was "Betty." Her office was stationed between the offices of Mr. Buchanan and Mr. Tullock but her fingerprints were everywhere. Most importantly, she was the heart of a sense of community that certainly integrated the students but also linked the students with the faculty.

### III. Ideas

Ideas, it seems, are frequently suggested by the posing of questions. At several points Mr. Buchanan posed questions that substantially influenced my research career and in this experience I know that I am not alone. I suspect that some of these questions were posed to me because I was recognized as one of the more technically inclined students, who was called upon when graphs and intuition about the logic began to fail.

Public Finance was the background specialty but Mr. Buchanan was interested in both the finance aspects of the public sector as well as the demand side. He recognized the great absence of theory about the efficiency of public

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decisions, or even a methodology for asking the questions. This recognition motivated many questions about the implementation of various mechanisms, such as voting, lotteries, games, contests or anything else that might apply to the assessment of the demand for public goods. Those questions lead naturally to the supply side and whether or not classical administrative and bureaucratic responded efficiently.

Mr. Buchanan was curious about a world which contained only public goods. He recognized that the classical Samuelson conditions required at least one private good and he was stumped about what might be the conditions used to describe efficient allocations when no private goods existed. Or, what were the conditions on equilibrium if unanimity is used in a world of private goods. In my second year as a graduate student he asked me what the conditions might be and in seeking an answer to that question I posed related questions that occupied the first years of my research career. The search for an answer took me through the early theory of linear inequalities and into the theory of convex cones and much of the theory of linear and nonlinear programming. As it turns out, the answer to Mr. Buchanan's question had been posed and answered much earlier by R. Frisch but, by the time I discovered Frisch, I had answered the question independently and was asking about majority rule equilibrium under the same conditions. I was also interested in how a group might find a proposal that all could agree to among a large set of options. Both of these extensions of Mr. Buchanan's question turned into important publications for me.

The work on equilibrium conditions in a world of public goods occupied my time well into my third year and I thought that they could be used as a dissertation. I raised the issue with Mr. Buchanan, who was by this time my advisor. He considered the time of year, which was early the first semester of my third year. He also reflected on the fact that I was on an Irwin Foundation fellowship and wondered what I would do for the rest of the year. He did not mention it but the fact was that he had been working on housing policies. The conclusion was that I should shift my effort to a new and different topic, the problem of grants-in-aid. I am not sure that I had a lot of input in that particular discussion. Anyway, my dissertation topic became urban renewal. Suspecting that time left on my fellowship might have more to do with when I graduated from the University of Virginia than the questions I was posing for research, I continued to work on questions related to the federal urban renewal program until it was time to graduate. By this time Mr. Buchanan was a sounding board for ideas and his excitement was infectious and a constant

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source of encouragement. The (second) dissertation resulted in a good publication.

Mr. Buchanan could see the tracks of public goods in places that had been obscured to others and his questions were constantly leading to discoveries about where the basic theory could be applied. The joint cost problem was recognized as having public goods aspects. Peak loads could be interpreted as involving public goods. Aspects of quality and location were put in the same category. One day he asked me how one determines where to put a fire station, a question that still challenges aspects of theory. To this he added issues about decision-making processes and new concepts of game theory. I recall his sharing his correspondence with Bob Aumann about cooperative games without side payments with a continuum of players. These questions continued to shape my thinking for years.

One of my most interesting experiences was when he handed me a first draft of his theory of clubs. I formalized the model and demonstrated that his major conclusions could be deduced as an immediate consequence of the problem formulation. To me the problem was trivial and I reported as much to him. Nevertheless, in spite of my criticism, the paper continued to circulate backed by his high opinion of it. Clearly, this was an important lesson for me. The lesson did not register with me at the time but when the paper became recognized as the seminal work for a new branch of theory, my attention and re-evaluation was evoked. The lesson was one that Mr. Buchanan had taught me many times through demonstration (but never through a lecture). It is the interpretation of the model and not necessarily the complexity of the mathematics of the model that makes it an important contribution.

### IV. Academic Exposure

Students were encouraged to get their ideas into print. I recall that John Gurley, who was editor of the *American Economic Review* in the early 1960s, claimed that he received more papers from Jim Buchanan students than the students of anyone else in the profession.

I think that this activity of U.Va. students was derived in large part by the confidence placed in them by the faculty. From my perspective the best example is the first meeting of what was subsequently called the Public Choice Society. The meeting was held in the fall of 1963 at the Faulkner House at

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the University of Virginia. I think that Mr. Buchanan managed to get funding for the project through Howard Hines of NSF and had put together what can now be seen as an impressive list of participants, including Duncan Black, James Coleman, Anthony Downs, John Harsanyi, Jerry Kramer, Eleanor Ostrom, Vince Ostrom, John Rawls and Bill Riker. The subsequent fame of the scholars on this list, as well as the others who were there, says something about the ability of the person who compiled it.

Mr. Buchanan asked me to prepare a reading list, a sort of bibliography, to define this emerging area. The interesting thing is that I was left alone to include what I thought was important and to ignore what I thought was not important. This was a major meeting for the faculty of the University of Virginia and to give a graduate student the responsibility for contributing to the definition of a new field really demonstrated the confidence he placed in his students. I felt this confidence, as did the other graduate students, and there is little doubt in my mind that it contributed to the success of the careers that Mr. Buchanan has touched.

I recall a bit of philosophy he gave me and I pass it along to my students. "From time to time in your career you will find yourself at odds with everyone else in the profession. Everyone might think that you are wrong. When that happens, study your arguments very carefully because they could be right. Then, if after careful review you can prove yourself right, stick with your position. It is one of your most creative moments." Of all of the things that Mr. Buchanan taught me this perspective is one of the most important.



## 32 James McGill Buchanan: A Classic Original Thinker

CHARLES J. GOETZ

James McGill Buchanan is a classic "original thinker" type. One of the things that sets original thinker geniuses apart from those of us in the common herd is that their minds often work in quirky, almost spooky intuitive ways.

My first glimpse at the inexplicably intuitive nature of original insight came when, as a teenager, I read a biography of the legendary physicist Isaac Newton. The book recounted how Newton had, in a matter of only a few days, arrived at the correct answer to a complex scientific problem set in the form of a "puzzle" by one of his acquaintances. But, although Newton knew the correct answer almost immediately, it then took him many months to *prove* the correctness of the answer. I remember being flabbergasted at how one could intuit an answer without immediately being able to adduce the chain of reasoning that led to the answer. It was as though someone could look at a page containing a thousand digits of numbers and, after brief meditation, confidently announce the correct square root. How could this be possible?

I was also intrigued by the "puzzle" method of investigation. How did one learn by contemplating puzzles for which there was not necessarily any derivable answer at all?

Only Jim Buchanan himself could attest authoritatively to the importance of intuition as the motive force in many of his great and insightful contributions to the field of economics. On the puzzle-making score, however, the evidence is clear, as many of his former graduate students can confirm. I remember the exams after which graduate students would ask in all seriousness "Was there an answer to question five?" knowing full well that there often wasn't. The test was of how one could grapple with the unknown.

Though lacking direct evidence, I am pretty confident that Buchanan was as full of scientific intuition as anyone I've ever known. And, I remember Jim telling me that "The trick is to look at a familiar question from an angle a hundred yards off from the usual perspective." Indeed, I can tie together

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intuition and puzzle-making with a brief anecdote that is amusing, instructive and quintessentially Buchanan.

About a year after I received my doctorate, I stopped by to visit Jim in his basement office in Rouss Hall at the University of Virginia, the headquarters of the Thomas Jefferson Center. I had in hand the manuscript of a just-completed paper in which I disproved a traditional rule of public finance: that the excess burden of a tax is minimized by taxing the good with the most inelastic demand curve. The paper was quite short and Jim read it immediately, growing more and more visibly excited as he continued.

Finally, he jumped up and headed for one of his filing cabinets, exclaiming "I knew it! I just *knew* that there was something wrong with that rule." In a minute, he brandished an old final exam in graduate public finance and handed it to me.

"Look, I asked that question on the final for Toby Davis' group, asked them to disprove the excess burden rule."

"But," he added wistfully, "*nobody got it right.*"

# 33 Learning from the Master: A Student Evaluation of Professor Buchanan

RANDALL G. HOLCOMBE

- I. Introducing... Professor Buchanan!
- II. Professor Buchanan in the Classroom
- III. Those Papers
- IV. Write It Down
- V. Concluding Remarks

More than two decades after leaving graduate school, I still feel like a student of Professor Buchanan's.<sup>1</sup> When I see him, I now call him Jim, but at the same time I think of him as Professor Buchanan, the person who, to use modern economic jargon, gave me the human capital to succeed as an academic economist.<sup>2</sup> Of course, because so many people have learned so much from his writing, in one sense there are a huge number of Buchanan students. His ideas have changed the way the profession thinks in fundamental ways, and many people whose main contact with Jim has been through reading his written work can legitimately call themselves Buchanan students. But considered more narrowly, only a privileged few (relatively speaking) have been

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1 What? Footnotes in a personal reminiscence (or student evaluation)? I am afraid so. This is how I was trained to write. The essay is about my experience as a Buchanan student, but all the footnotes are more specifically about me, so if you don't want to know any more about me, you can skip the footnotes. Unlike Marshall's Principles, there is nothing important in the footnotes, and the footnotes contain no equations.

2 I do not mean this to slight the many others who have enhanced my human capital both inside and outside the classroom, but Jim Buchanan's role in my education has made a large impact in three ways. First, I wrote my dissertation under his direction; second, much of my subsequent work has been in public choice, which he was so instrumental in developing as a field; and third, I have learned much from his teaching besides just economics, which is the topic of this essay.

## LEARNING FROM THE MASTER

Buchanan's classroom students, and I am one of them. This essay reminisces about some of the things I learned from Professor Buchanan in addition to economics. I will discuss not what he taught, but how he taught. His ideas can be found in his writing, but Buchanan's teaching methods have been revealed to a smaller group. I must confess that Professor Buchanan's teaching methods have had a huge influence on me, and for more than two decades I have taught my graduate students by trying to emulate the type of instruction I received from Professor Buchanan in the early 1970s.

### I. Introducing... Professor Buchanan!

As an undergraduate I took a special topics course on public choice that used *The Calculus of Consent* as one of its textbooks, so I was introduced to the work of Buchanan and Tullock prior to meeting them in person, and like many economics graduate students at Virginia Tech at that time, I went there because they were there.<sup>3</sup> I was not disappointed. I did not take any classes from Buchanan or Tullock until my second year, but I quickly felt their presence in seminars they gave, and just as impressively, in seminars they attended. Buchanan and Tullock seemed to me to be in a class by themselves. While others looked at the details, both Buchanan and Tullock systematically looked at the big picture. Others might ask questions in seminars about estimation techniques, or about modeling strategies, while Buchanan and Tullock asked more fundamental questions (or, especially in the case of Tullock, launched more fundamental attacks) on the very foundations of a presenter's work.<sup>4</sup> Before I had either of them in class, I developed a tremendous respect for their perception, and for their ability to separate out the fundamental ideas from the technical details. Buchanan and Tullock were men with ideas.

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3 I had also been accepted to the University of Virginia with a similar financial aid package, and it was a tough decision as to where to go. In hindsight, I am sure I made the right choice, for more reasons than I can go into in a footnote.

4 I do not mean to slight the other faculty by these comments. With few exceptions, all of my professors in graduate school were very bright people who taught very good courses, and I benefited greatly from their instruction. But there was still, in my mind, two tiers of faculty, with Buchanan and Tullock alone occupying the top tier. My impression is that most of my classmates felt the same way.

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As a first year graduate student, it was hard for me to say Buchanan's name without Tullock's. They had co-authored *The Calculus of Consent*, then barely a decade old, and together were pushing ahead to establish this new subdiscipline of public choice. Their names could have been one word, BuchananandTullock. Being a graduate student at the public choice center at that time was quite exciting, if one could see the excitement through all of the work that graduate students are expected to do. My classmates and I were at least a decade too late to get in on the ground floor of public choice, but we could feel the intellectual excitement of the new subdiscipline ready to break through and become a part of mainstream economics. A large proportion of our professors were working on public choice ideas, and there was a continual stream of outside speakers who managed to get to out-of-the-way Blacksburg to give seminars on public choice topics. Public choice was more than just a field of inquiry. It was the intellectual nucleus of the whole graduate program. Those not so interested in public choice might have viewed this as a lack of balance within the department, and a liability. For a student interested in public choice, however, the public choice center provided a special kind of atmosphere, under the leadership of BuchananandTullock.

### II. Professor Buchanan in the Classroom

As a second year student I took courses from both Buchanan and Tullock, and as much as BuchananandTullock seemed like two components of a single entity to a first year graduate student, they were two completely different entities in the classroom. There was Buchanan, and then there was Tullock. As anybody who knows Gordon can easily imagine, Professor Tullock was always willing to debate students in class, and students quickly learned that if they said anything in class, they had better be prepared to defend it. Tullock did not tolerate dumb ideas, but even good ideas were subject to scathing attack.<sup>5</sup> Buchanan was just the opposite. Any student comment was entertained as a potentially good idea.

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5 Through experience, I learned a bit about debating strategy from being a student in Gordon's class. After losing some classroom debates to Tullock when I felt I had the stronger argument, I went back to analyze how it was that Gordon managed to get the better of me, learning both how to engage in debating tactics myself, and how to

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I can recall times when one of my classmates would say something in class that was ill-conceived enough that I was truly embarrassed by it.<sup>6</sup> Rather than attack an idea like this, Professor Buchanan would suggest that the idea had some interesting possibilities, if one just thought about it a little differently. Then he would proceed to restructure the argument, changing it a little bit here and a little bit there, until it emerged as a very interesting insight. I was amazed at Professor Buchanan's ability to turn ugly ducklings into swans in this way, and to this day, this is one of the most enduring lessons that I received from being a classroom student of Jim Buchanan.

The contrast between Professor Buchanan and Professor Tullock in this regard was like night and day. In Gordon's class, one learned that any student's idea, no matter how good, was sure to contain some flaw that could lead to its destruction. In Jim's class, one learned that any student's idea, no matter how bad, could be recast and reworked to discover a valuable insight. Let me say to readers who know Jim Buchanan in other ways, but who never were exposed to Professor Buchanan the classroom teacher, this was, for me, probably the most remarkable thing about having sat in Buchanan's classroom. I wonder if other of his classroom students share my impression. One thing Professor Buchanan's approach does is make students feel more comfortable about expressing their ideas in class. Sometimes too comfortable, I thought as a student, leading my classmates to express ideas that sometimes were embarrassingly incoherent. But the second advantage to Buchanan's approach, which is much more valuable to students, is that it shows students how to work with ideas and develop them into well-reasoned insights.

As a student, I was able to see James M. Buchanan, the future Nobel laureate, stand before me and develop ordinary ideas, or even what I judged to be bad ideas, into good ideas and profound insights. His thought process was exposed to me and my classmates, and we saw not only the final product – the good idea – but also how that good idea evolved from something more ordinary. What I really learned in Professor Buchanan's classroom was how to organize my thoughts and structure my ideas, and how to start with some basic idea and make it into something better. Beyond a doubt, this was the

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avoid falling for the debating traps that Gordon would set. My recollection is that after a year of Tullock courses, I was better able to hold my own in a debate with him. And classroom discussions with Tullock definitely were debates.

<sup>6</sup> I must concede the possibility that I, too could have made statements in class that embarrassed my classmates. You can finish this paragraph to see why, if I did, I might never have known.

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biggest benefit that I received from being a classroom student of Professor Buchanan's.

### III. Those Papers

In Professor Buchanan's graduate public finance class, students wrote a lot of papers. Every couple of weeks we handed in short papers that developed our own original ideas on topics that would be assigned to us. When he told us on the first day of class that we would be writing all those papers, my first thought was, "How am I going to be able to come up with so many original ideas on all these different topics?" My only consolation was that Professor Buchanan had been making these assignments for years, and if all those students who came before me could do it, I probably could too. And of course, in the end I did, and so did my classmates.

The first thing I learned from writing those papers was that I could, in fact, do it. I did the assignments, of course, but I did more. Starting only with a topic, I was able to think about it, do a little reading, and then I was able to develop my own original ideas on that topic, and I was able to do it time and time again. I learned that I could write a paper on any subject, even if when I started, I didn't know what the paper would be about. That lesson has carried over into my academic research, and has encouraged me many times to familiarize myself with some interesting body of ideas, knowing that in the end I could use those ideas to develop my own work. Rather than think, "I really can't afford to learn about this because it is too far afield from my own research," I think, "I know that if I spend some time learning this literature, I can develop my own original ideas to contribute to it." Intellectual curiosity can always pay off in terms of academic publications, which of course is one of the main metrics by which academics are measured.<sup>7</sup>

Writing is a crucial skill for anyone with a graduate degree, and Buchanan's paper assignments helped my classmates and me develop our writ-

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<sup>7</sup> I modestly refrain from offering references to my own work as evidence, but to the degree that my work has spanned a wide variety of topics and subject areas, much of that is due to the confidence I first got in Buchanan's class that one can choose a topic to write on first, just because one is interested in the topic, and then with some research and thought write an article (or more) on that topic.

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ing skills. Buchanan's papers helped in other ways too, because they focused on the development of ideas, and the creative aspects of getting started on an idea rather than the more technical aspects of completing a research paper. In the same way that sitting in Professor Buchanan's classroom could help the attentive student see how to develop a good idea, the paper assignments reinforced that by pushing students to develop their own ideas – a lot of them in a short period of time. It was good training for writing, but it was especially good training for critical thinking. I assign my own graduate students a series of short papers just like I wrote as a graduate student, and tell them they can credit (or blame) Jim Buchanan for the idea.

### IV. Write It Down

How do you actually develop ideas, starting from what might appear to be the kernel of a good idea and crafting it into a final product? The lesson I learned from Jim Buchanan is, write it down. I write here only from my own limited experience, and can only conjecture how Jim acted toward other graduate students, and toward colleagues. Outside the classroom, Jim has always appeared to me to be reluctant to talk at any length about ideas in the abstract, but has always been very willing to discuss written work. When I came to him with an idea for my dissertation, he said only that it sounded interesting, and that I should write it down and then we could talk about it. I did write down just what we had talked about earlier, and then we discussed it at length. The procedure was that I would write something down, and then we would talk about it.

That was good discipline, and discipline that I still follow, for several reasons. First, writing ideas down helps to develop their logical structure. It helps the writer to better understand the ideas, so improves them, and it also helps eliminate problems that become more obvious once ideas take their written form. Furthermore, discussing written ideas helps the writer see the next step. In conversation, one can always answer an objection by saying, "Yes, but..." whereas with a written paper, if the qualification or caveat is not already in the paper, the paper writer knows what must be done to shore up a weak part of the analysis. Although I have never been a colleague of Jim's, my impression is that he works the same way himself. Rather than try out an



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idea on people in conversation, he will write it down and ask them what they think of his paper.

This is yet another lesson that I have learned from Professor Buchanan. If I ever have an idea that I think is worth developing, the first step I take is to write it down. Before that, it is simply a thought, but after it is written down, like a paper for Professor Buchanan's class, it is an idea in its infancy, waiting to be developed. Readers who have seen a listing of Jim's working papers can see that he works the same way, and that the way that he tries out his ideas and prepares them for further development is to write them down.

Jim has attributed his success in part to his work ethic, and of course one cannot produce academic output without, as he says it, applying the seat to the chair. There is more to it than this, however, because once seated, some people use their time more productively than others. Professor Buchanan showed me, in so many ways, how to be productive in the time I am seated. His lessons extended from how do develop a good idea, the importance of writing down ideas, and the payoffs to intellectual curiosity. Yes, he had some economics to teach along the way too, but this can be picked up by reading his own research. Being a classroom student of Jim's brought with it much more than just training in economics.

### V. Concluding Remarks

I was fortunate to have been a classroom student of Jim Buchanan's, but as I hope this essay points out, the main benefits of that classroom experience came not from the economics I learned, but from what I learned about methodical thinking, about organizing and developing ideas, and about taking ideas from their most embryonic stage and developing them into papers, dissertations, articles, and books. Jim did teach a good course, and I appreciate the time he put into preparing the course and all of the public finance I learned in class. But I have learned much more economics from Jim by reading his work since I graduated than I learned in the brief time I spent in his class.<sup>8</sup> In contrast, the lessons I learned about how to develop a vague idea

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8 Considering the amount of time that has elapsed since I sat in his class, that is probably as it should be. As difficult as it is for me to comprehend it, that was more than a quarter of a century ago.

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into written form, to refine it, and to shape it into an academic publication, gave me the "human capital" to succeed in the academic marketplace.<sup>9</sup> Of course, I am relating only my own impressions and experiences, but I am confident that they would be shared by a large number of Jim's former classroom students. One piece of evidence is that so many of them have made their own marks in the world of ideas.

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9 For readers who know me (or perhaps worse yet, who have never heard of me) and want to question the degree to which I have succeeded, I will point out that I am a tenured professor. Can anyone doubt that the guarantee of permanent employment is an excellent indicator of success?

## **34 James M. Buchanan Outside the Classroom: A Former Student's Perspective**

DAVID N. LABAND

There is a quaint expression that runs something like, "don't let college interfere with your education." I can say that, at least in my case, there was much truth to this saying. For the most part, I remember little of my undergraduate education in economics at Virginia Tech, completed in March 1978. Allan Mandelstamm pricked my interest in economics with his microeconomic principles course, taken early in my sophomore year. But my love affair with economics as a science was initiated by my contact with two professors during my senior year: Barney Lentz and Bob Tollison. Barney, who later became my longtime professional collaborator, taught a superb course in labor economics. Bob, who subsequently became my mentor in graduate school and the early part of my academic career, as well as an occasional research partner, introduced me to rent seeking and the Leviathan State in the context of a fascinating course on Mercantilism.

For a variety of reasons, having nothing whatsoever to do with the scholarly eminence sitting on my doorstep, I decided to stay at Virginia Tech to pursue my doctoral studies.<sup>1</sup> It was during my second year, in his graduate course on Public Finance, that I experienced personally the depth of analysis that I have found to be so characteristic of Professor Buchanan's work. Yet this was by no means the defining point in my early development as an economist. What is etched into my memory and has defined both my own thinking about what is of fundamental importance to economic (indeed all) science and my understanding of, and appreciation for Professor Buchanan results from two specific private interactions with him, and my ongoing observations of his behavior from a distance, while in graduate school.

At about 4 in the afternoon on Christmas Eve 1980, I tapped on Professor Buchanan's office door to offer him departing wishes of the holiday season. Upon entering, I was immediately struck by his unnatural pallor and desolate mood. Nonetheless, I rather stammered out my hope that he enjoy a merry

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<sup>1</sup> Indeed, in 1978 when I started graduate school I was essentially ignorant with respect to the intellectual capital in economics available at Virginia Tech.

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Christmas. He responded painfully slowly by saying something like, "I'm afraid it's not going to be a very merry Christmas for me this year...." Seems a donkey that he was very fond of had died earlier; this had sent him into a black depression on the worst of days.

Those readers who have had the pleasure of visiting Jim's farm outside of Blacksburg, Virginia will know that he is an animal lover to the core. Having raised a small menagerie of different pets over the years, I was deeply touched by and sympathetic to his pain. So it was that by approximately 4:15 p.m. on Christmas Eve 1980, my surrogate mother during graduate school, Betty Tillman (who also doubled at that time as Jim's secretary), and I were working the telephone trying desperately to find someone in the local area who had a Christmas donkey to sell. Indeed, lady luck smiled on us that evening: the manager of a farm near Christiansburg had several. We went out for a look in the bitter cold and light snow flurries and promptly acquired an adorable young donkey, that was small enough to fit in the back of my small truck (with a camper shell). By 5:30 or so when we pulled in to the driveway of the Buchanans' country home, it was pitch black. Now Betty Tillman has had many "finest hours," but, to me, this was the finest of her finest: she marched up to the door and convinced Jim that I had something that he simply had to see without delay and dragged him out into the inky Blacksburg winter to the back of my truck. At roughly the same instant as Jim craned his head forward to peer into my truck, the little donkey peered out. The look on one of those two faces has been etched into my memory for nearly 20 years now. Perhaps it was a newly-discovered Christmas spirit, it's hard to say in retrospect. I do know that Jim allowed as how he probably had a spot in his barn to keep little Pedro.

Now Pedro wasn't always on his best behavior. Donkey that he was, he was perfectly capable of making an ass out of himself. He was a bit of a ladies' man, so to speak, to the chagrin of the local grazing fauna and the occasional embarrassment of Jim and Ann. But I saw that little donkey help heal a man's heart one night. A little thing, perhaps. But all of these little things become the man who, in turn, has so profoundly influenced us all.

High summer in Blacksburg comes in late July and August. One of the surefire indicators is the seemingly sudden appearance of blackberry bushes laden with fruit. Back in those days (the early 1980s) Jim was a journeyman vintner who made blackberry wine. So it was that one glorious July afternoon, Bob Tollison, Jim and I shoehorned ourselves into the cab of Bob's tan truck and headed out to do some berry picking. I don't recall much about the

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berries; I do recall snippets of the conversation we had on the way. Jim was bemoaning the fact that he hadn't had any good ideas, inspirations, or insights pertaining to economics in several weeks. I, of course, was flabbergasted and utterly dejected. Not at the possibility that a scholar like Jim Buchanan had the occasional slow spell, but at the hopelessness of my own situation. Until very recently I had been under the impression, carefully fostered by my undergraduate professors, that there were no unanswered questions or issues in economics. As I progressed through graduate school, it gradually dawned on me that perhaps there were occasional disagreements among professional economists and interesting topics to write on. I'd likely struggle, but had some hope that I could contribute to the professional literature. These thoughts were dashed by Jim's comments. If HE was having trouble identifying useful contributions to make to the scholarly literature of economics, then I was doomed to failure. Of course, it didn't turn out that way, on two counts. First, there are lots of contributions to be made, some more important than others. Second, and relatedly, Jim has a lifelong habit of making really insightful contributions with considerable intellectual depth. What HE refers to as an idea or insight is just a little different than what most of the rest of us refer to. Nonetheless, his emphasis on ideas, not technique, made an enormous impact on this aspiring scholar.

My strongest and most enduring impression of Jim Buchanan, and lesson learned from him, was formed from arm's-length observation. I watched one of the most accomplished and famous economists in the world come to work each morning at 6:30 and work all day until 5:30, Monday through Friday. He returned for evening seminars. As justified by whatever project he was working on at the time, he devoted weekends to his scholarship. His labors were labors of love for his work, seasoned by devotion to really understanding the problems and issues he tackled. For most of us, excellence requires such a work ethic because we're not innate geniuses. This is especially so in my own case. We each learn this truth in our own way. Jim Buchanan unknowingly, by personal example, conveyed this critical and enduring truth to me during those years in Blacksburg. It is the foundation upon which my own career has been erected.

## 35 Blacksburg, Virginia: Summer, 1977

ROBERT SUGDEN

I first met Jim Buchanan in the summer of 1977.

I was then 27, a young lecturer in economics at the University of York, with very few publications to my name, quite a few good ideas, most of which I hadn't written down, and no very clear sense of direction in my research. In those days, university teaching in Britain was a much more leisured activity than it is now. It was still possible to get a tenured position in economics after finishing a master's degree, without having had any real apprenticeship in research. If you entered the profession in this way, as I did, you were asked to do what would now seem an astonishingly small amount of teaching and administration. It was expected that you would spend a reasonable – but not excessive – amount of the remaining time on research, but no one required you to formulate research plans or to submit reports to appraisers. The hope was that, given time and benign and unintrusive encouragement, you would mature into a first-class economist. It was easy to drift. It was also easy to lose self-confidence when you were working so much on your own, and getting the usual unhelpful rejection letters from journals. Both of these were beginning to happen to me.

I had had the idea of spending a summer in America, and had thought I might be able to finance this by teaching in a summer school. Alan Peacock had suggested the names of a few American professors that I might write to; one of them was Jim Buchanan. With my letter, I had sent a copy of a paper I had just written. It was one of my good ideas: it was about Amartya Sen's theorem of the 'impossibility of a Paretian liberal'. It argued that Sen's way of formulating liberty was misguided: Sen was trying to express the idea that people should be free to make certain choices for themselves, but he was using a theoretical framework of coherent 'social preferences' in which social choices are modelled as if they were made by a benevolent despot. It seems that, by a stroke of luck, my letter reached Jim just after he had presented a similar argument to a seminar at the Public Choice Center, and had completely failed to persuade his audience. I was invited to spend the summer of 1977 as a visitor at the Center, with all my expenses paid. It was the first time anything like this had happened to me.

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It was also the first time I had been to America. Everything was new to me. I loved the small-town atmosphere of Blacksburg and of the sleepier towns around; I loved the humid heat which was so different from England; I loved the fireflies and the forests and the Appalachian mountains; I loved working in the Public Choice Center in its colonial-style house in the trees. I attended my first Liberty Fund conference, a two-week event at the Marriott in Blacksburg. Jim Buchanan, Gordon Tullock and Robert Nozick each gave a series of lectures. I began to understand the mix of conservatism, libertarianism and populism that makes up the Virginian approach to public choice.

Not that I agreed with it all: being in America helped me to see how different American political thought is from European. I couldn't share the American sense of government as an alien intrusion into individuals' lives. And though the state of the British economy in 1977 didn't exactly inspire pride, I wasn't convinced (as many people I met were) that Britain was in a state of terminal decline, destined for economic and political stagnation on the Eastern European model. But, more than anything else, what induced me to think seriously about this mix of ideas was listening to and talking with Jim Buchanan. I admired the strength of his convictions, his rootedness (as it has always seemed to me) in an historical tradition. I admired his sense that economics is not just a game for mathematicians to play, but a way of trying to understand the world as it is. Most of all, I admired his intellectual integrity – his openness to new ideas, his willingness to listen to opposing points of view, his impatient rejection of bad arguments even when they appeared to support his own position. He became one of my intellectual heroes.

The idea of Jim's that had most resonance for me was his rejection of the benevolent despot model of government, which underlies so much of welfare economics and social choice theory. This line of thinking connected with my own, still only partly-formed, critique of Sen's account of liberty. It also appealed to a streak of populism in my own intellectual make-up. I have never been able to empathise with the self-assurance of those British economists who write as though the country is run by a small elite group of high-minded leaders – politicians, senior civil servants and of course academics – and as though they themselves are (or ought to be) members of the club. Nor have I felt easy with a related style of writing in moral philosophy, in which the object is to make clear the nature of the social good, as understood by right-thinking people, in the apparent expectation that this will provide guidance for the sort of high-minded leaders imagined by the economists. I discovered that Jim's contractarian approach provided the conceptual foundations for a

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radically different understanding of public choice, in which the aim is not to seek the good, but to seek agreement among individuals about how best to contain their conflicts and to achieve whatever ends they have in common. Ever since I learned this from Jim, it has surprised me how difficult it is for economists to grasp the logic of contractarianism, and to understand how it is possible to say something useful about economic and political choices without presupposing any conception of the overall social good.

In any event, when I returned to Britain in the autumn of 1977, I had a new sense of direction in my work: I had found the current of thought to which my developing ideas belonged. And I had that extra confidence that comes when your unconventional conclusions are supported by someone whose judgment you respect. Twenty-two years on, I can see the summer of 1977 as a turning-point in my career. Thank you, Jim.



## 36 A Birthday Reminiscence

KAREN I. VAUGHN

My first acquaintance with Jim Buchanan was through reading *Cost and Choice* in around 1974. I had seen the book referenced in a paper on the economic calculation debate that I was assigned to discuss at a SEA session that year. Since I knew next to nothing about the debate, I went and read all the works referenced in the article so I would have some ability to judge the paper. I have been forever grateful that I took my assignment so seriously at the time, because my work led me to study an issue that was to influence my entire subsequent career. And one of the most important influences dating from that time, was the work of Jim Buchanan.

I remember finding *Cost and Choice* to be deep, difficult and endlessly fascinating. I must have read it through at least three times, and though I found the discussions therein to be elusive, I was convinced that Professor Buchanan, as I then thought of him, was on to something very important about economic theory. That the cost of alternatives forgone was only equal to the price of the product in full general equilibrium was a proposition I pondered at length, wondering what implications to draw from this apparently subversive insight. I pondered so long that several years later I was drawn to examining the question in print in "Does It Matter That Costs are Subjective?" (SEJ, 1980) a question that I still regard as at the heart of my own research. That is, puzzling out the implications of the fact that humans are heterogeneous individuals who evaluate choices according to their own interpretations and criteria.

*Cost and Choice* was not my only point of intellectual contact with Jim. I count as one of the lucky breaks in my career being invited to a series of summer conferences that Jim organized at Virginia Tech during the late seventies and early eighties. There, for the first time, I was surrounded by economists with whom I felt a definite rapport. My early career was spent at the University of Tennessee, a place where a free-market price theorist, as I thought of myself, was in a distinct minority. (Once, when asked by a senior colleague who were my favorite living economists, I unhesitatingly answered, "Milton Friedman, Armen Alchian and James Buchanan." To that, my colleague sniffed, "Those three would be at the bottom of my list." To put

## A BIRTHDAY REMINISCENCE

this in perspective, if I were to name that colleague, it is doubtful that any reader would ever have heard of him.) While the political atmosphere in which I worked improved markedly when I moved to George Mason University, it is still the case that for several years the high point of each year was my trip to Blacksburg and my participation in the week long Liberty Fund Conference associated with the Public Choice Center. There, I was exposed to outstanding speakers from a variety of disciplines, provocative ideas and a camaradery that I have since learned is rare in academe. At the hub of both the ideas and the camaradery was James Buchanan, who, I believe, was at his happiest during those times.

Jim was a true inspiration to me during those conferences. He seemed to know everyone, to have read everything and thought everything that was interesting and important. I would make note of the books he recommended and try to read them when I got back to Fairfax. What I wrote about during the year was largely a reflection of what was discussed during the summer before. However, even more significant for a young professor, was the implicit academic values Jim practised during discussion. Jim treated everyone around the table as an equal regardless of age, rank or stature. The only entry into favor was a good argument, period. And for me, there was no higher praise than hearing Jim say to a speaker undoubtedly far more established and renown than I, "She's got you there!" offered with that little chuckle of appreciation that Jim's friends will immediately recognize. For the first time in my short career I began to believe that I could hold my own with the best of them. And the jokes! Jim liked jokes and so it seemed that the week was full of them, both during the sessions and after in our organized social events. We were like kids in political economy summer camp, working and playing so that we could hardly tell the difference. I can truly say that I only started my career in earnest after having learned how much fun intellectual discourse can be at those Blacksburg conferences.

I am no longer a young assistant professor, trying to decide what contribution I might make to a profession peopled by intellects of the quality of Jim Buchanan. I have written some good things, made a few contributions of which I am proud, made a few I would like to forget. And, since those heady conference days at Blacksburg, my interests have gone over more and more to the Austrian tradition. But there are aspects of Jim's thinking that endure as I go about my own work. Substantive things like the central role of individual evaluation in assessing rules and outcomes, the importance of recognizing all aspects of subjectivity in explaining events and in examining policy, the crucial role of constitutions for bringing about agreement. Even

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crucial role of constitutions for bringing about agreement. Even more important, however, are the attitudes toward our mutual enterprise that I first found exemplified in Jim Buchanan.

While the title of his memoir, *Better Than Plowing*, is accurate, it is also in its own way misleading. I have always had the impression that Jim regards the academic life as *much, much* better than plowing, perhaps even akin to a sacred calling, were he to believe in such things. And because it is so much better than the lives that most other people lead, we had better work hard to justify our enviable positions. I also learned from Jim Buchanan that ideas matter, that we have an obligation to tell the truth as best we understand it, and that we should never think we have all problems settled for all times. The world for us is a big "relatively absolute, absolute." However, this does not excuse us from being as honest and as useful as we can be in our intellectual endeavors. If that were all I learned from Jim Buchanan, (and, as I have said, there was really so much more) that would be enough to celebrate eight centuries of life rather than a mere eight decades. So, for all you have taught me and countless others, Jim, I say, happy, happy 80th birthday. As the Chinese say, "May you live a thousand years!"

## 37 First Encounters with James Buchanan's Scholarship: A Personal Reminiscence

EDWIN G. WEST

As an economics teacher in England, the late 1950s and early 1960s was a relatively uninspiring intellectual period for me. While the discipline of economics was still absorbed with Keynes, microeconomics was usually engrossed in static neoclassical models of efficient allocation in contrast with market failure. Theories of government failure had not yet appeared, and when they did they came from the U.S.

Prospects for me changed round about 1961 after I received messages (directly or indirectly) from Harry Johnson to the effect that the real excitement and action was to be found, not in Europe, but in the U.S. And the subjects to look out for were: industrial organization, international trade, and public economics. Echoing these same sentiments, with respect to public economics, my Ph.D. supervisor, Jack Wiseman urged me to focus especially on what an economist by the name of James Buchanan was doing.

My first acquaintance with Buchanan in print was his *Public Principles of Public Debt*, published in 1958. His discussion of the problem of the burden on future generations was remarkably penetrating, as was his attack on the notion that "we owe it to ourselves". His use of subjective cost concepts was important here in demonstrating that we do not owe the debt to ourselves, but that the burden is shifted to future generations. But what Buchanan was most critical of was the contemporary assumption of Keynesian economists such as Lerner and Tobin that deficits were not the cause of high interest rates, high taxation, and low growth. Reviving the classical position, Buchanan responded by focusing on the erosion of inherited traditions of discipline that held deficits in check. We have to recognize, he has since maintained, that the natural proclivities of citizens favor deficit financing because: "Constituents enjoy receiving the benefits of public outlays, and they deplore paying taxes. Elected politicians attempt to satisfy constituents."<sup>1</sup> But Buchanan's

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1 BUCHANAN, JAMES: "The Moral Dimensions of Debt Financing", in: FINK AND HIGH (1987).

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greatest challenge, eventually, was to ask how could the Lerner/Tobin type reasoning explain the explosion in public debt, relative to taxation from the 1950s to the 1970s (a relatively full employment period). It is remarkable how attitudes have changed when, in 1999, we have the U.S. President in effect boasting that the Goliath of deficit financing has at last been slain. For the first time in three decades, President Clinton announced in his 1999 State of the Union Address, the budget is now balanced. "From a deficit of \$290 billion in 1992, we had a surplus last year [1998]. We are on course for budget surpluses for the next twenty-five years".<sup>2</sup> This change in mind-set on deficits has taken its time and has been difficult to accomplish; but Buchanan's early and persistent stand on this subject against his professional peers surely deserves the fullest recognition.

My next sampling of Buchanan's academic work also occurred around this period. This time it was his assistance with the Italian sections in the distinguished and most helpful publication of *Classics in the Theory of Public Finance*, (1958, MacMillan, N.Y.) edited by Richard Musgrave and Alan Peacock. Unilingual scholars world wide must have cherished the appearance of this work. Reaching back to 1880, the Musgrave/Peacock volume introduced us for the first time to a distinguished line of public finance specialists in Italy, Austria, France, Germany and Sweden and whose main interest was the optimum distribution of resources between governments and the private sector. Buchanan's chapter consisted of his translation (from German) of Knut Wicksell's essay "A New Principle of Just Taxation". Again I found the material unexpected and stunning in its logic and implications. As is now well known, Wicksell frequently opposed simple majority voting democracy because it was in danger of injuring the poor who are usually in the minority. The only way to prevent the "tyranny of the majority", Wicksell insisted, was the adoption of the principle of unanimity.

Wicksell's essay has obviously had a profound influence on Buchanan's subsequent work as well as on others. Not that one is automatically persuaded to go as far as the full extreme of unanimity rather than revised voting rules that are marginally more inclusive than the usual simple majority. More interesting is the connection between Buchanan's discovery (or rediscovery) of the Wicksell essay and the emergence of the discipline of Public Choice. After all, the classic work *The Calculus of Consent* by Buchanan and Tullock

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2 "The Text of the President's State of the Union Address", *New York Times*, Wed. Jan. 20, 1999, P.A2.

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appeared only four years later, and Chapter 6 of this work is an attempt at a practical response to Wicksell's unanimity proposal.

My third example of Buchanan's scholarship, and again one that initially must have taken his readers by surprise, was his entry into the debate on the Arrow theorem. It will be recalled that Arrow's objective was to find a social welfare function that satisfactorily ranked alternatives according to the aggregation of individual ordinal preferences. The fact that none was found led to much pessimism about the potential of democratic institutions. Buchanan entered the debate by focusing on Arrow's claim that the ordinary decision-making mechanisms of (a) voting and (b) the market, do not allow rational social choice. To regard rationality as an attribute of the social group, Buchanan insisted, "implies the imputation to that group of an organic existence apart from that of its individual components". (Buchanan 1954, p. 116.) If we don't like this conclusion then we must return to the decision-making of individuals as the only alternative criterion. Unfortunately, Buchanan observed, Arrow *appeared* to many to have given the impression that his findings of irrationality with respect to the social welfare function implies that the decision-making processes of individuals are also basically irrational. If this is true both voting and the market become suspect or unsatisfactory.

But suppose that conceptual social welfare functions are completely divorced from ordinary (group or individual) decision-making processes, what remains of Arrow's analysis? Could he not introduce consistency as a requirement of rationality? Buchanan's answer is again quite firm: while consistency of majority voting implies that the values of the individual voters do not change during the decision-making process, this is quite unrealistic in practice. Democracy calls for "government by discussion" and this means that individual values *do* change. "If individual values in the Arrow sense of ordering of all social alternatives are unchanging, discussion becomes meaningless." (Buchanan 1954, p. 121.)

Majority rule is not necessarily consistent in the sense of providing the basis for a unanimous social welfare function primarily because it can override the wishes of minorities. But in a free society it is acceptable because the median voter is constantly shifting. It allows "jockeying back and forth among alternatives, upon none of which relative unanimity can be obtained." (Buchanan 1954, p. 119.) But notice that the "jockeying" backward and forward "becomes a means through which the whole group ultimately attains consensus, that is, makes a genuine social choice" (*ibid*, p. 119). In this way

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Buchanan pushes in the direction of Wicksell or toward unanimity, now referred to as "relative unanimity".

I think that it is remarkable that the seminal Buchanan publications discussed here covered only four years, from his *JPE* piece in 1954 to *Principles of Public Debt* in 1958. While much of his prolific work subsequently has been jointly authored, I have selected only single contributions and they have come from the exceptionally creative surge of the 1950s. Speaking for myself, I now regard it as more than a blessing that Jack Wiseman and Harry Johnson sent me those messages when they did!<sup>3</sup>

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3 As luck had it I got to know Jim Buchanan in person in the mid-70s when I was visiting scholar at the Public Choice Center in Blacksburg, Virginia. These were also "vintage years".

## 38 James Buchanan's Influence: A Personal View

LELAND B. YEAGER

James Buchanan began influencing me before I even met him. *Prices, Income, and Public Policy: The ABC's of Economics* (McGraw-Hill, 1954) is a concise Principles text written by Clark Lee Allen, James M. Buchanan, and Marshall R. Colberg. I used that excellent book in teaching a one-semester course at the University of Maryland. It helped me face two challenges: of distinguishing between essential ideas and fringe refinements of economics and of putting the essentials across to students in one semester. Although ensuing years offered me fewer and fewer opportunities to teach the Principles course, I never thought that teaching it was a degrading chore. Economists avid to demonstrate technical expertise should remember that the strands of economics of which ignorance does the worst damage are precisely the basics, not technicalities giving rise to the most easily gradable test questions.

Jim Buchanan brought me from Maryland to the University of Virginia in 1957. A year or more of discussions had apparently been triggered by his liking a paper of mine on growth theory and money in the March 1954 AER. At a cocktail party following my job seminar in the spring of 1957, when asked what I would like to drink, I replied "Bourbon and water." Jim told me afterwards that that was the correct answer.

Jim assured me that if I moved to U.Va. I would receive promotion and tenure on a prompt schedule. Strange as it may seem nowadays, when impending tenure decisions cause so much anguish, I hardly gave the matter any further thought; and Jim's assurances did come true.

While I was still new at U.Va., Jim and Warren Nutter established the Thomas Jefferson Center for Political Economy. The Center brought distinguished economists to live and lecture at the University for several weeks or months at a time. We Virginia economists thus got to know such eminent figures as Frank Knight, T. W. Hutchison, Overton H. Taylor, and Maurice Allais. Gordon Tullock joined the Department as a postdoctoral fellow and later, after a few years at the University of South Carolina, returned to U.Va. as a faculty member. Buchanan and Nutter put me in charge of a series of lectures that wound up composing *In Search of a Monetary Constitution*



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(Harvard, 1962). Lecturers included Buchanan himself and visitors such as Milton Friedman, Jacob Viner, Murray Rothbard, Clark Warburton, Clarence Philbrook, and Willford King.

I am grateful to Jim Buchanan for his patience with me during a period of depression. I am especially grateful because - or so I understand - not everyone enjoys the benefit of his patience. My blue mood started around 1959 or 1960. I managed to keep muddling through with my regular duties, though painfully. I can mention the episode now, but in those days I hesitated to discuss it or seek professional help for fear of staining my medical record. My sociability, never great, plummeted further. I finally managed to shake off the gloom, thanks to self-help books and to a beneficial change of scene made possible by a leave of absence. I spent the academic year 1961-62 partly in Arlington, Virginia, and later as a visiting professor at Southern Methodist University. There the benevolent understanding of Mathilda Homan was particularly helpful.

Especially after returning from SMU, I took pleasure in the monthly dinner meetings of the Political Economy Club of Virginia, which had been organized by Buchanan and Nutter and eminent faculty members in other parts of the University. Early meetings, in 1959, featured talks by Rutledge Vining on his vision of political economy, and by Ronald Coase, who published his paper the following year as "The Problem of Social Cost". After unfortunately falling apart, the club was briefly reorganized under a new name after Buchanan and Tullock had moved to VPI. It held meetings in Charlottesville and Blacksburg but fell apart again because of the policy-induced gasoline shortage of 1974.

I admired Buchanan's stance in misunderstandings between the Department of Economics and the U.Va. Administration. Ignorant gossip had given the Department a wildly inaccurate reputation for antiintellectual right-wingery, even as a wholly owned subsidiary of the John Birch Society. Partly because of this reputation, the University failed to accord Ronald Coase and Gordon Tullock and others the deserved recognition necessary to keep them on the faculty. In 1968, making good on his warnings, Buchanan himself resigned.

Now I'll return to Buchanan's influence more specifically on my thinking as an economist. Economics, he insists, is not properly an assortment of quasi-mathematical exercises in maximization subject to constraints. That conception would make economics almost a kind of engineering. Economics properly investigates not so much the optimal allocation of resources as the

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coordination of millions of interdependent but separately decided activities. Coordination involves mobilizing scattered knowledge and bringing diverse entrepreneurial insights to bear. I remember Jim's excellent talk on these themes at a one-day Charlottesville conference on Austrian economics. By the way, although Buchanan's views overlap Austrian economics in several respects, he was never a card-carrying member of the Austrian school. He is too independent a thinker.

Buchanan's conception of a market economy as the coordination of diverse activities and knowledge carries over into the money-macro field. It is perverse to conceive of macroeconomics as the study of conditions under which aggregate demand is excessive or deficient or is just at the Goldilocks level for absorbing aggregate supply. The apparatus of aggregate demand and supply apparently appeals to textbook publishers as a device for building on what students supposedly learned in microeconomics. The rationale of the apparatus is very different and much weaker in macro than in micro, however, so that the mistaken analogy is actually subversive of the student's understanding.

A fruitful approach to macroeconomics builds on Buchanan's conception of economics as a study of processes of voluntary cooperation. Prosperity or full employment prevails when the activities and decisions of millions of diverse persons and organizations mesh together well. Recession or depression is a state of discoordination. Then, for example, unemployed persons would gladly spend their wages on more goods and services if only they could find jobs, and firms would gladly hire more workers if only they could sell more goods and services. What keeps these desires from meshing? Significantly, the apparent scarcity of jobs and customers prevails widely across almost all sectors of an economy in recession. Conceivably, and apparently in fact in a few historical episodes, the discoordinating disturbance is a real, nonmonetary one. Overwhelming historical experience, however, readily understandable with micro and monetary theory, points to a mismatch between the demand for and quantity of money. It is along this line of research that Buchanan's emphasis on coordination and discoordination directs us.

To mention a more specific influence, Buchanan's "*Ceteris Paribus*: Some Notes on Methodology" (SEJ, Jan. 1958) carries a widely applicable message. It is illegitimate to theorize about the consequences of one specified change in conditions while trying to hold constant other conditions that simply cannot remain constant in the face of the one specified change. It is pointless to give high marks to a supposed set of institutions having verbally at-

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tractive properties ("democratic socialism", perhaps) but whose components are mutually inconsistent. Buchanan also influenced me in discussions over my early manuscript on "*Methodenstreit* over Demand Curves" (JPE, Feb. 1960); he even supplied the title of that article.

Like the Austrians, Buchanan has championed subjectivism in economics. One of its greatest triumphs was his own demonstration (in: *Public Principles of Public Debt*, 1958) that the burden of government spending can indeed be partly shifted into the future by bond-financed budget deficits. Conventional wisdom had been unduly materialistic: the burden cannot be shifted through time, economists had claimed, since resources are used when they are used. Buchanan recognized that a burden is something subjectively perceived. Persons who willingly give up current command over resources in exchange for government bonds that they find attractive perceive no burden in doing so. It is in the future that people - in general, people other than the original bond-buyers - will bear the burden of paying taxes to service the debt or of losing through its outright or inflationary repudiation.

Besides demonstrating sound methods at work, Buchanan has written many welcome paragraphs of *countermethodology*, trying to free his fellow economists from harmful methodological badgering. He deplores the diversion of attention from real-world questions on which economics at its best can contribute answers, and indeed the disparagement of such attention, by a "scientific" turn that cultivates displays of mathematical and econometric technique practically for their own sakes. As he has famously written, an article chosen at random out of any modern economics journal is unlikely "to have a social productivity greater than zero." As he recalled in his 1986 Nobel lecture, he has "rarely been teased by either the currency of policy topics or the fads of academic fashion, and when I have been so tempted my work has suffered."

To return to influences that Buchanan has exerted beyond economics narrowly interpreted, I'll mention that his conversations and writings over the years have given me insights into a kind of egalitarianism, or at least a kind of reaction against economic privilege, that is not clearly incompatible with classical liberalism and individualism.

Buchanan's many writings on contractarianism have influenced my thinking on political and economic philosophy. I wind up more an adherent of the brand of utilitarianism championed by David Hume, Ludwig von Mises, F. A. Hayek, and Henry Hazlitt. But as I have sometimes tried to explain, those

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two apparently different philosophies differ less in substance than in terminology.

One final example of why I feel gratitude to Jim Buchanan is his consent, a few years ago, to become the first Associato Distinguite (Distinguished Fellow) of Union Mundial pro Interlingua. UMI strives to promote knowledge and use of interlingua, which is the product of teams of professional linguists working over many years. Interlingua standardizes the vocabulary possessed in common by the Romance languages and English, a vocabulary activated by a simple but complete grammar. That language can serve well as an easy-to-learn means of international communication. Furthermore, its naturalistic quality and objective nature give it great interest for linguists and social scientists. Members of UMI are grateful for Buchanan's support.

## 39 'Is GMU Big Enough for Buchanan?'

WADE J. GILLEY<sup>1</sup>

On the day we brought Jim Buchanan's potential appointment before a George Mason University Board of Visitors committee, a member of that board declared, "The question isn't whether Jim Buchanan is big enough for George Mason but rather whether or not George Mason is big enough for Buchanan!"

This comment came at the end of a series of discussions extending over many months regarding the movement of Virginia Tech University Professor James Buchanan and his Center for the Study of Public Choice to George Mason University. It was at that meeting that the university's Board of Visitors approved the appointment of Dr. Buchanan, his long time colleague, Gordon Tullock, and other faculty members to be tenured faculty at George Mason University. (At George Mason, following a long term precedent acquired from the University of Virginia, the governing board made appointments with tenure and was thus involved in the biggest academic development in the university's history.)

George Mason began as a University of Virginia center in the 1950s, became a free standing university with authority to offer master's degrees on April 19, 1972 and gained approval to offer two doctoral degrees, education and economics, in 1979. In 1983 the faculty consisted primarily of two groups: a pre-1972 undergraduate liberal arts coterie with a misconceived University of Virginia mind set and a contentious 1972 to 1978 pre-George Johnson circle. One yearned for the slow paced undergraduate branch college days when one could be a University of Virginia faculty member without having to measure up. The other, recruited from the 1960s graduate cohort, was contentious about governance. The faculty generally considered themselves to be underpaid and overworked – not an unusual circumstance then or now in American higher education.

With the approval to offer a doctorate in economics, Mason was challenged to improve its faculty. Some had been appointed – Walter Williams,

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1 J. Wade Gilley, president of Marshall University from 1991 to 1999 became president of the University of Tennessee on August 1, 1999. He was senior vice president of George Mason University from 1982 to 1991.

## IS GMU BIG ENOUGH FOR BUCHANAN?

Jim Bennett, Manuel Johnson and Karen Vaughan come to mind – but more with substantial experience in teaching doctoral students and supervising dissertations were essential. The possibility of Buchanan and his colleagues joining Mason at this time was a godsend. Not only were they world class but their brand of economics – Public Choice – was clearly in vogue in Ronald Reagan's Washington, D. C.

A hurdle to be overcome was the question of compensation. At Virginia Tech Buchanan's salary was almost twice that of the highest paid full professor at George Mason and the issue of faculty salaries was among the most contentious in a faculty substantially unnerved by the thought of the university moving to a new level and looking for issues. To get Buchanan and company was a huge coup for the university – but would the governance structure survive the shock? George Johnson was ready to forge ahead but the provost was anxious, reluctant to make a recommendation to the board committee. Karen Vaughan and the economics faculty were committed, but how to explain the differential in pay to the faculty at large with salaries such a subject of contention?

In the discussions, the provost and others began moving down the path of not how much the university could afford to pay but rather was Buchanan worth that much to Mason?

That was when a long time member of the board – and some would say founder of George Mason as a university – John T. "Til" Hazel spoke up, "The question isn't whether Jim Buchanan is big enough for George Mason but rather whether or not George Mason is big enough for Buchanan!"

Buchanan was appointed and the rest is history.

As the administrator (senior vice president) designated by Johnson to handle the recruitment of Buchanan and company in 1982, I had worked on most of the details, including the question of compensation. In that process, as a novice in the field of economics and the appointment of high priced professors, I proceeded cautiously but with ever rising hopes. For example, after deciding to talk to some noted economists about Buchanan I discovered that it was universally expected that he (and perhaps his colleague, Gordon Tullock) would one day receive the Nobel Prize for Economics as the founder of the Public Choice school of thought. And Buchanan had very strong support from corporations and foundations, raising the possibility of Mason gaining support for its emerging economics doctorate. (Since that time Mason has received literally millions of dollars of support from individuals,

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foundations and corporations attracted to the university by Buchanan's presence.)

After Buchanan's move to Mason the university attempted to draw attention to the success of the young institution in attracting world class faculty in economics and information technology and engineering. But it was difficult to convince the media that Mason's faculty profile was on the rise. We routinely received comments from reporters such as, "Everybody has faculty with degrees from Harvard or Yale."

In what some thought was an act of desperation, I took two initiatives. First, in the spring of 1985 we placed three-quarter-page advertisements in the Sunday Outlook section of the Washington Post (every other week for six weeks) modeled after public policy ads routinely placed by the Mobil Corporation. The first one carried the title, "What do Harvard, Chicago, UCLA, MIT, Columbia and George Mason have in Common?"

The commonality was that the six universities each had on their faculties three or more of the economists profiled in Blaug's book "The Greatest Economists since Keynes."

About the same time, while a Post reporter was visiting, I announced that Mason had recruited six faculty members (from places such as Virginia, UCLA, Vanderbilt and Illinois) and had paid them more than \$100,000 each (remember this was 1985). At that time there was a pattern emerging of universities "buying" prominent faculty and \$100,000 was more than most university presidents were being paid in 1985.

The Post reporter said, "Wow! They must be good if you're paying them that much." That led to a major story in the Post, which was rerun in many daily papers across the nation over several weeks.

The "Mobil Ad," as George Johnson characterized it, was clipped by the bureau chief of the Wall Street Journal in the spring of 1985 and during the congressional recess in August that year a WSJ reporter was assigned to check out the Mason Economics Department. The visit by David Shribman (now the Washington D. C. bureau chief for the Boston Globe) to Fairfax that summer led to a front page, 53 column-inch article in the Wall Street Journal on the emergence of George Mason University on the national scene. We were told that the article was syndicated by the WSJ and appeared in dozens of daily newspapers across the nation in the following weeks. It was followed by major articles by many national newspapers and journals.

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Then in August of the following year, 1986, I was awakened early one morning by a telephone call from Helen Ackerman who excitedly told me that Buchanan had won the Nobel Prize.

In the weeks that followed, Mason continued to receive an enormous amount of national and international publicity. With its profile soaring, the university became known in higher education circles as "The George Mason Miracle."

In the period prior to Buchanan, George Mason was receiving about 7,000 student applications for about 5,000 spaces – freshmen, transfers, graduate students and law students. In the fall of 1987, Mason received more than 22,000 applications for some 5,800 new student spaces.

The proof of a pudding is in the eating – or so it is said. And that was true at George Mason. Clearly, Jim Buchanan was too big for Mason in 1983 and that fact was proven again and again. But fortunately, people such as Til Hazel and George Johnson knew that and, being entrepreneurs of the first order, they seized that opportunity and others to make George Mason "The Miracle of the 1980s" in American higher education.

But it couldn't have been done without Jim Buchanan and his colleagues.



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