
MARKET, STATE AND RULES-BASED WELFARE

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Abstract

The problem of complex relations between Market and State as providers of individual and collective welfare has been a main concern of philosophers and political economists at least from Adam Smith, and is also in the centre of current political debates on the economic crisis in general and on severe fiscal crises that Welfare States face, in particular. The paper addresses this problem in terms of Public Choice Theory and, respectively, its extension, Constitutional Political Economy, a new research program that has been developed in recent decades.

Keywords: market, state, public choice, constitutional economics

1. Introduction

By changing the name of his research program – from Public Choice in Constitutional Political Economy or Constitutional Economics – James M. Buchanan, winner of the Nobel Prize for Economics in 1986, separated himself from those parts of the Public Choice literature too tributary on post-war Welfare Economy of Keynesian extraction [1]. The ‘milestone’ of this research program was putted, as is known, by James M. Buchanan, along with Gordon Tullock, with the publication of *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (1962) [2]. This already classic work founded a comprehensive economic theory of organization of human activity, which I consider relevant including and, in some way, especially for the post-communist societies. As Robert D. Tollison also indicates, the relevance of extensive analysis undertaken in *Calculus* is apparent today particularly in the post-communist world. The ‘constitutional choices’ are here at the order of day, as economies make a difficult transition to free market institutions, a very large scale process that raises many debates about the set of fundamental rules of this ‘new social order’ [3].

Indeed, the deep constitutional reforms of these societies, including of the Romanian one, consists fundamentally, in the general argument of this theory, in the *choice-separation* between ‘privatization’ and, respectively, ‘collectivization’ or ‘statization’ of organized human activities based on a large consent of individuals-citizens (re-) became free to make choices and to act. “At

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a time of major worldwide constitutional changes”, Ludwig Van den Hauwe also notes, „it will come as no surprise that the focus of public choice discussion is shifting away from ordinary political choices to the institutional-constitutional structure within which politics takes place” [4].

In most general terms, Public Choice, respectively, Constitutional Economics comparatively examines the actual properties of rules and institutions – that is, more precisely, Market and State – within which individuals-citizens of contemporary societies *cooperate*, and the processes by which these rules and institutions emerge or are deliberately chosen. As Buchanan reveals itself, by its emphasis on voluntary *choice*, constitutional economics differs from conventional economics, while with its major interest for *cooperative* human interaction, not *conflictual*, it differs from much of conventional political science [1].

This theory treats the *political* organization of contemporary societies using the conceptual and methodological frameworks of their *economic* organization. Declining *ab initio* any attempt to design a Constitution of a perfect or ‘ideal’ State or Polity, Buchanan and Tullock aimed, instead, to examine and comprehensively develop to its ultimate logical consequences *the calculus that, theoretically, would make the rational individuals asked to adopt the Constitution of their country*, meaning by that term no more, but nor less than “a set of rules that is agreed upon in advance and within which subsequent action will be conducted” [2, p. 13].

The article is organized as follows: the first sections (1, 2, 3, 4) outlines the general conceptual and methodological framework of this research program, then presents an application (5), and in the final section (6) discusses some more recent analyses and evaluations of it.

2. Methodological individualism

This theoretical approach explicitly assumes the ‘methodological individualism’ [5], always specific to *mainstream* economic theory, since the individuals are considered to be the unique decision-makers or ‘choosers’ both in their *private, economic* actions, as well in their *public, political* actions. The economic theory, at least from Adam Smith onwards, has analyzed in detail the individual choice process in the private sector of market economy, but the political theory has ignored and largely continues to ignore the necessary *extension* of this process and its consequences in public domain, which provides however the only logical ‘bridge’ between *individual choice* and *collective* or *public choice*.

Thus, the authors have developed a theory of public choice starting from the fundamental and elementary postulate of methodological individualism according to which collective actions can be understood and explained if and only if they are ‘decomposed’ in their component individual actions. And this theory is *economic* because assumes that individuals have *heterogeneous*

expectations from the collective action; in other words, their interests are irreducibly different.

In any case, any theory of human organized action must provide an explanation of how the different interests, even contradictory, of individuals are reconciled. Economic theory has demonstrated long time ago that individual interests reconciles through market exchange. Moreover, the authors argue, if we assume that people's interests are identical, it would not be necessary any economic theory. "If all men were equal in interest and in endowment, natural or artificial, there would be no organized economic activity to explain. Each man would be a Crusoe. Economic theory thus explains why men co-operate through trade: They do so because they are different" [2, p. 7].

Political theory, in turn, must take also into account the major consequences of this elementary observation that collective or political actions are ultimately the result of interactions of their individual participants with different interests.

3. What is the State?

For adepts of the 'organistic' or 'collectivist' conceptions, the answer to this question is quite simple. They assume the existence of a 'will' or a 'general interest' separate and independent of the wills and interests of individual members of the State, which is designed like a (supra-) individual, so that the only task of the theoretical exercise is to explain the 'scale of values' that inspires and motivates the actions of this *überindividuell* entity, the State. Although developed in the European cultural environment, especially in Germany, this conception does not belong to the 'mainstream' of Western philosophical thought according to which the individual is the fundamental ontological entity. Therefore, political theory relevant to contemporary democratic societies reject this view.

Buchanan and Tullock reject also the Marxist conception which considers the state to be an 'exploitation' tool of the poor by the rich. Rejecting equally organicist and Marxist conceptions, the authors argue for an individualistic conception of the collective unity or the State. "Collective action is conceived as the action of individuals when they choose to accomplish their goals rather collectively than individually, and the government is seen as nothing more than the set of processes, the machine which allows such collective action to take place. This approach makes the state into something that is built by men, an artefact. Therefore, it is by its nature subject to change, perfectible." [2, p. 18]

This model of state is 'populated' by different individuals with different goals both in their private and public or political actions, and reasonably agrees on a set of rules to guide their actions. Needless to say that this kind of 'state' does not exist in reality, but it is an abstract 'construct' whose simple and clear structure can be theoretically fruitful. However, the analysis of the choice process of fundamental rules, which begins *de novo*, can be easily extrapolated to the analysis of existing rules in the actual states, in order to 'improve' them.

The starting point of such abstractly built constitution, or of possible improvements of the existing constitutions, is the *consent*, meaning that there are taken into consideration only those improvements deemed to be beneficial by all members of society. Real constitutions that were usually adopted without the agreement of all are not subject to this theoretical analysis. The authors imagine, *in abstracto*, a constitutional debate where all members of society would participate, preoccupied, if not suspicious that their interests would be preserved in situation of their absence from this debate.

4. Economic order and political order

According to the economic theory, the individual that makes market exchanges is motivated by his private interest. But it must be immediately added that the validity and general applicability of economic theory does not depend on the existence of a fictional, *pure homo economicus*. Economic theory does not explain however *all* human activity, but only the *typical* human behaviour in the market. Moreover, economists have never denied the existence of non-economic exchanges, in the strict sense. For various reasons, some individual, but especially *collective* buyers, deliberately pay to sellers higher prices than would be necessary to acquire some goods or services; and some individual or collective sellers sometimes accept lower prices than buyers would be willing to offer. However, the fundamental assumption of economic theory on human motivation simply argues that “*the representative or the average individual, when confronted with real choice in exchange, will choose ‘more’ rather than ‘less’*” (*italics added*) [2, p. 22].

But what motivational assumption may be appropriate for political theory? Economic relationships, as well as political relationships, are acts of cooperation between two or more individuals: *Market* and *State* are the institutions which make the social cooperation possible. In the market, people cooperate producing and exchanging goods and services to their mutual advantage. Likewise, people cooperate in politics, *exchanging with each other private goods to get some public goods*. In an exemplary way, Crusoe and Friday admitted that it was mutually beneficial to specialize and to share their work products: coconuts for fish; and also to initiate ‘political exchanges (negotiations)’ and to allocate the necessary resources to produce the common good: a house for both. Therefore, general motivational hypothesis is that the *same* individual, guided by the *same* fundamental values acts in the two domains of his activity – economical and political. So in political domain he does not immediately seek the ‘general interest’ or ‘general welfare’ as it was assumed by traditional political philosophy for centuries, but ‘maximizes his own utility’; he remains a “self-interested maximizer” [2, p. 23].

As Dennis C. Mueller more recently summarized, from general perspective of this theory, *political man* and *economic man* are ultimately one and the same [6]. “Man is a political animal”, said Aristotle, thinking that human beings are naturally inclined to political activity. Adam Smith, in his turn, noted

as well the natural propensity of man 'to change one thing with another'. From these two essential, paradigmatic observations of the two great thinkers have developed two disciplines in human sciences: political science, respectively, economic science.

These two disciplines have been long time separated by the questions they have formulated, by the fundamental assumptions about the motivations of individual actions, and by the methodologies used. If political science has studied individual behaviour in public, political domain, assuming, often implicitly, that it seeks the interests of others, economic science has investigated individual behaviour in the market, assuming explicitly that it seeks his own private interests. "But is this dichotomy valid? Could both Aristotle and Smith have been right? Could political man and economic man be one and the same?" [6]

The answer is affirmative. In fact, already Max Weber noted that "the political enterprise (*Politikbetrieb*) is necessarily an enterprise of interest (*Interessenbetrieb*)" [7], a comprehensive perspective shared and further developed by Joseph A. Schumpeter [8], Anthony Downs [9], James M. Buchanan, Gordon Tullock and many other contemporary authors who elaborate within this research program, substantially stimulating the progress of current Political science.

Some theorists have tried to explain the political process on the assumption that, in this domain, the individual tries to maximize its power over other individuals [10]. And indeed, the individual that maximizes *power* in the political process and the individual that maximizes *utility* in the economic process seem to be similar; but such an inference is completely wrong, in fact. The two approaches are different in a fundamental philosophical sense. Public choice theory, assuming that individual is a utility-maximizer in economic domain, as in political domain, does not assume *in the same time* that such individual increases its utility *at the expense* of others. According to this theory, political activity is a particular form of exchange (*politics-as-exchange*), and, as in economic activity, anticipates mutual gains for all parties involved. Therefore, organized political activity is conceived as essentially a means by which all participants' power *increases*, 'power' being understood as the ability to do things that are desired by people. From this perspective, genuine political activity must prove to be in the benefit of all members of the society. Or, to use the terminology of game theory, *political process is conceived as a positive-sum game* [2, p. 25].

By contrast, the power-maximizing perspective presents the political process as a *zero-sum game*. The power of one individual over other individual can not simultaneously be increased for both individuals: what wins one, the other loses. Thus, the political process is converted to the opposite of fundamental economic relationship based on reciprocity of gains from exchange, not in something like this.

According to public choice theory, laws and democratic political institutions can be made intelligible by postulates of economics. Even the Basic Law, the Constitution, can be understood starting from economic hypothesis on human motivation. So, in what circumstances an individual may accept that it is 'advantageous' to enter into a 'political' relationship with his fellows? Or, in more general terms, under what circumstances "a society composed of free and rational utility-maximizing individuals chooses to undertake action collectively rather than privately?" [2, p. 37].

In order to answer this general philosophical question, Buchanan and Tullock adopt an economic perspective, based on costs. Therefore, the individual may admit it advantageous to participate in a collective action *if and only if he expects to increase its own utility in this way*. And collective action may enhance the individual utility in two different ways: 1) reduces *external costs* ('negative externalities') caused by possible private actions of other individuals (for example, police prevents or impedes the theft of his car); 2) provides *external benefits* ('positive externalities') at a lower cost than these could be offered by private action (organization of fire department reduces fire danger on his house).

This analysis starts, again, from the hypothetical situation of a 'society' in which there is no collective action, so that the (social) benefits of the organization of such an action can be compared with its (social) costs. Its main virtue is that it allows a comparative evaluation of two generic ways of organizing human activity, private and collective, respectively, market and state, based on the costs of their organization.

Thus, collective action is a means to reduce the external costs imposed by some private actions of individuals. Government activity is so directed to reduce these external costs. From this activity, the individual's utility is maximized when net costs of its organization are minimized. And there are two distinct cost elements of any human activity: as we have seen, the individual costs incurred as a result of actions of other individuals, on which he can exercise no control (*external costs*); and *organizational costs* incurred by the individual due of his/her participation in collective action (*decision-making costs*), given the number of participants and their common objective of reaching an agreement regarding that collective action. In sum, these costs are called *costs of social interdependence and their minimization is always a highly desirable goal in any society*.

All these general assertions concern the fundamental theoretical problem of justification of 'the role of the state' in the contemporary constitutional democracies. From the perspective of analysis undertaken here, the rational, utility-maximizer individual chooses *between* voluntary cooperative organization and collective organization, through the government, respectively, chooses *privatization* versus *collectivization* of economic and social activities based on comparative evaluation of their total costs.

This analysis is relevant especially for comprehensive constitutional reforms started de novo in the post-communist societies more than two decades ago. Privatization, respectively, collectivization of some entire spheres of

economic or social activity must take into account the overwhelmingly importance of costs-benefits criterion, inherent in the two generic types of organization of human activity.

5. An application: interest groups and ‘general welfare’

In contemporary societies, economic interests are predominantly manifested in the form of organized interest or pressure groups. This phenomenon, which can not be concealed or treated as an ‘aberration’ of the political process, puts into question the traditional, predominantly normative conception about political order. The spectacular emergence of interest and/or pressure groups, whose activities have effects especially evident on the parliamentary and governmental, central and local decisions, it is in contradiction with this conception that policy-makers altruistically follow the ‘public interest’ or ‘general welfare’, defined as something independent of individual and group private interests.

But trying to define more precisely the interest groups faces the difficulty in defining, in the first place, the ‘general welfare’. If the latter can not be satisfactorily defined, it is, in principle, impossible to determine the extent and manner in which the activities of these interest groups prevent or delay it. This evaluation can not be conclusive in the absence of clearly defined criteria.

A path followed by some economists is to define it starting from a complete description of a ‘social welfare function’. “This function conceptually orders all possible states of society, and quite unambiguously, allows for the selection of the ‘best’ or from a restricted set of available alternatives, the relatively ‘best’” [2, p. 39]. However, in order to describe this function, individuals must make explicit their own value judgments. Therefore, the ‘social welfare’ is ultimately what individuals say it is, so there are as many social welfare functions as many individuals exists in society: *because individual evaluations are irreducibly different.*

Therefore, Buchanan and Tullock do not follow this path. Instead of trying to define a social welfare function to rank all possible states of society, they prefer to declare their total ignorance of what is ‘good’ or ‘bad’ for ‘society’, admitting that the ‘best’ is only those states or changes that may be approved in principle by *all* members of society. Thus, any change that has unanimous support is certainly ‘desirable’. If the individuals cooperate through political process to obtain mutual advantages, then, *in principle*, everyone can be *better off* by any change that makes mutual advantage possible.

Practically, however, the unanimity criterion does not help much in defining the public interest, because decisions are usually adopted under rules weaker than unanimity. Thus, there is no criterion for determining the degree to which public interest or general welfare is promoted by operation of common rules (majoritarian) of legislative or executive decision-making. *There are only private and group interests - some are promoted and others are thwarted* [2, p. 50].

The real politics undoubtedly attests an unprecedented expansion of the range and size of differentiated or discriminatory legislation ‘production’ dedicated to these groups in all societies. Likewise, the investments of organized groups have increased considerably to capture ‘political advantage’ by their more and more obvious involvement in the legislative and executive political process, at central and local levels. And, as has been observed, *the total social costs of all these evolutions are certainly enormous* [11].

If the legislative and executive decisions of political power would be adopted so that the benefits and costs are equally distributed on entire society, individuals and groups would have little incentive to try to use the political process in order to obtain advantages, some at the expense of others. However, few or perhaps none of the policy decisions can be reduced to these general dimensions. In fact, any political decision is likely to provide greater benefits to some individuals than others, as any conceivable distribution of costs may push harder on some individuals than on others.

These differentiated benefits can be obtained in two possible ways. First, political power may take decisions that provide benefits to *some* individuals and groups and the costs being supported by *entire* society, as is the construction of a *regional* road with funds from the *central* budget, for example. Second, policy decisions may be adopted providing benefits to *all* members of society, the costs being incurred only by *some* individuals and social groups. External costs are imposed precisely by this irreducible difference in the distribution of benefits and costs among members of society.

One way out of this situation could be provided by adopting the principle that those individuals and groups that receive differentiated benefit, to bear also differentiated costs. The adoption of this principle could produce results similar to those of a *general* policy, at the scale of entire society. “The proper principle for politics is that of generalization or generality. This standard is met when political actions apply to all persons independently of membership in a dominant coalition or an effective interest group.” [12]

With a very familiar example, suppose that it would be required funds from the central budget to support a declining mining local area. If would establish a special tax on the inhabitants of this area, it would be largely a form of self-defence. But if such support is granted by the governmental budget from general tax revenues, a real ‘Pandora’s box’ may be opened. Thus, farmers and manufacturers of food, clothes or even cars and so on, who would claim that ‘they are in decline’, may request and receive support from the government budget, imposing, as a consequence, excessive external costs on all tax-payers.

Therefore, the conceptualization of some legislative modifications, *even at the constitutional level*, in order to reduce excessive external costs imposed by operation of interest groups in contemporary democratic processes is a very important task of political science today. For this, pressure groups should be accepted as inherent in the political process. According to the analysis undertaken here, their presence and activities are the predictable result of the initial behavioural hypotheses. “Scientific progress in the analysis of politics

cannot be made until this widespread activity is fully incorporated in the analytical models” [2, p. 212]. This inclusion does not ask the economic or political analyst neither to endorse, nor to reject this type of activity on moral grounds. After all, economists do not say that individual *must* ‘maximize utility’, but simply they start from this hypothesis in their analyses.

6. Final evaluations

A frequent critique of this economic theory of politics is that it induces a pessimistic, even cynical perspective on ‘human nature’. But this theory offers plausible explanations of economic and political phenomena, and thus is empirically confirmed, regardless of ‘attractiveness’ of human characters which ‘inhabit’ it. Although, properly speaking, the character from this analytical model may seem, *ethically*, unattractive, *intellectually* it is in any case much more credible than the ‘masks’ that freely parade in public, media and even academic current discourses.

In fact, if viewed more closely, this theory proves to be quite optimistic as far as political activity is essentially conceived as a form of human activity that makes possible the multilateral benefits. According to this view, political activity, such as economic activity, is a *cooperative* genuine human effort making possible some benefits for *all* participants. It is true that today dominates especially the view that the political process involves a struggle with few winners and many losers, the first obtaining their gains only at the expenses of the latter. If things would be irreparably so, then, indeed, political order could be ensured only by moral (self-)constraints of the participants in the political process, its *scientific* approach could hardly be distinguished from *moral preach or sermon*.

Another critique is that the theory is ‘ideologically biased’. As James M. Buchanan notes, the source of this criticism is in the mind-set of political economists and scientists from the middle of last century, when this theory has emerged. At that time, socialist ideology was very influential throughout the world, including the Western countries, being supported by the ‘theoretical welfare economics’, which was organized around the central idea of ‘market failure’ to achieve the general welfare [13]. „But failure by comparison with what?“, Buchanan rightly asks. The implicit presumption of this theory was that the government corrective interventions on market economy would work perfectly. “In other words, market failures were set against idealized politics.” [14]

Until half a century ago, political economy approached public policy as follows: *In principle*, competitive market economy enables the most efficient allocation (or ‘Pareto-optimal’) of resources in a society; or, in other words, in terms of Italian sociologist, it can not *improve* the situation of some individuals or social groups without *worsening* the situation of others. *In fact*, such optimal outputs in resources allocation are obstructed by different types of ‘market failures’ like macro-economic imbalances, monopolies or externalities, so that

„the government must intervene to correct market failures and maximize social welfare” [15].

Public choice theory initiated another line of argument, starting from a really basic question: How are collective decisions actually taken? They are taken by policy-makers, politicians, bureaucrats and voters trying to maximize their own utility. Ruled by self-interested actors on a ‘political market’, the government is often unable to correct market failures or, at least, to correct them at lower costs, less than the costs of market failure itself, an objective which, in fact, it is not at all a foregone conclusion.

Public choice theory asserts that politicians, organized in parties, want to win elections, in other words, not to remain politicians, but to become rulers in order to allocate and distribute public resources. To achieve this goal, they propose public policies which are preferred by most citizens. “Parties formulate policies in order to win elections”, wrote Anthony Downs, “rather than win elections in order to formulate policies” [9, p. 28]. In a similar way, the bureaucrats try to maximize their own utility, of course, under the constraints exerted upon them. They continually maximize budgets for offices and government agencies because only in this way they can increase their own direct or indirect reward. This general finding is supported by a large number of empirical studies that show that total costs of public bureaucracies are much higher than those of private enterprises.

Therefore, Buchanan considers that those who believe that this theory is immoral because it shows that people, in politics as in economy, behave interested, starts from an old misunderstanding. Economic model of behaviour does not *exhaust* the scientific explanation of human behaviour. In fact, people act for many reasons, and economic model identifies only one possible impulse of their actions. Public choice theory starts just from the assumption that people do not readily become “economic eunuchs” [14, p. 9] as they shift from economic sphere into political sphere, the economic model of behaviour losing thus its explanatory and predictive potential.

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