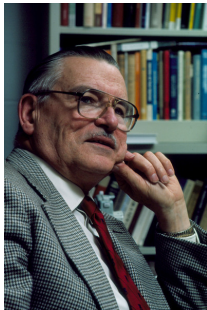


Origins of the state (1/2)



Recap: Market failure as a rational for state intervention

- The standard model of market exchange assumes a *completely decentralized* form of social organization.
 - Coordination *exclusively* via the price mechanism.
- General Equilibrium Theory demonstrates that this form of organization can achieve a Pareto efficient allocation of *private* goods.
 - All relevant information is transmitted via equilibrium prices.
- However, '**market failure**' is predicted in presence of externalities / public goods.
 - Prices do not reflect the relevant "social cost" (or benefits) of individual choices.
- One possible "fix" is for a central authority to correct prices. (The *Pigouvian* approach.)

Recap: Market failure as a rational for state intervention

- Inefficiency implies that there exist **opportunities for mutually beneficial changes** to the “equilibrium” allocation.
- In reality, voluntary *private* exchange beyond pure “price taking” behavior can achieve additional Pareto improvements.
 - Mutual agreement to *private contracts*.
 - Voluntary membership in *private organizations* that include hierarchical structures and / or rules of joint decision making.
- But: Under many circumstances, such private solutions may fail to materialize.
 - Prohibitively high transactions costs, e.g. when externalities affect very large numbers of individuals.
- Then, ‘efficiency’ may require a ‘state’ to **coerce** individuals to participate in collective actions **without their explicit consent**.
 - But without consent, how can we know that the arrangement is Pareto improving?

Questions

- How should a 'state' with the power to coerce make decisions?
- (How) can we ensure that citizens benefit from state intervention?
- (How) is the coercive enforcement of collective decisions compatible with the individual **sovereignty of citizens**?
- Under what circumstances can we expect a state to act in the interests of its citizens?

Two perspectives

- **Today:** The state as a product of a (hypothetical) 'social contract' (Buchanan 1975, Buchanan and Tullock 1962)
- **Next:** The state as an historically evolved set of social institutions created by self interested actors (Olson 1993)

The constitutional economics perspective

- James Buchanan approached these kinds of questions from *social contract* perspective (in tradition of John Locke, Thomas Hobbes, David Hume)
- *Hypothetical* account of how government can be founded on **agreement** between sovereign individuals
 - Identify *reasons* for rational individuals to agree
 - Show that *in principle* such reasons may exist (legitimacy)
 - Suggest that perhaps (some parts / aspects) of government were actually established through agreement
- Attempts to *legitimize* and / or *explain*
 - existence of government generally
 - specific *forms* of government (e.g. constitutional democracy)
 - possible *reforms* of government

The “State of Nature”

- 2 individuals, A and B
- One scarce good X (“falls down”)
- X is rival and excludable (private)
- No property rights, no law (no one “owns” any amount of X)

Individuals allocate time and effort to three types of activities:

- **Productive:** collecting X available in nature
- **Predatory:** attempting to ‘steal’ from other’s ‘stock’
- **Protective:** protecting ‘their’ stock of X from others

Rational individuals will optimally allocate their time between the three types of activities.

The “Natural Distribution”

- In ‘equilibrium’, the marginal benefits to an extra minute spent collecting, defending, or stealing are equalized.
- Buchanan calls the equilibrium allocation the “**natural distribution**”
- The ‘natural distribution’ will depend on relative physical strengths, aggressiveness, etc.

Inefficiency

- The ‘natural distribution’ is inefficient. (Why?)
 - Time and effort spent on non-productive activities.
- Inefficiency implies (as always) that there is a potential for *mutually beneficial agreement*.

Disarmament

- Both parties benefit if they agree on some distribution of X and “disarm”.

Constitutional contract

- Parties agree on a distribution of X along with a cessation of attack / defense activities.
- The constitutionally specified distribution of X will likely *differ* from the natural distribution. (Why?)
 - more resources will become available (more time for production)
 - extra resources need not be divided equally or in proportion to natural endowments
- This contract establishes basic *property rights*: individuals ‘own’ some amounts of X (by virtue of having agreed on this!)

Problem of compliance

		B	
		Respect Rights	Steal
A	Respect Rights	19,7	3,11
	Steal	22,1	9,2

- At the '**constitutional stage**,' all individuals would like to agree on (*Respect, Respect*)
- But at the '**post-constitutional stage**,' it's individually rational to *Steal*

⇒ Social Dilemma

Problem of compliance

		B	
		Respect Rights	Steal
A	Respect Rights	19,7	3,11
	Steal	22,1	9,2

Social Dilemma

- Although all individuals are better off if property rights are respected, each is tempted to “defect” (steal).
- As long as the other person's strategy is taken as *given* (irrespective of what that strategy is), it is rational to defect (steal). (Defection is a dominant strategy.)
- Defection is rational *unless* the individual expects that it will *cause* the other person to defect as well.

Problem of compliance

		B	
		Respect Rights	Steal
A	Respect Rights	19,7	3,11
	Steal	22,1	9,2

- In **small groups**, compliance with a constitutional agreement may be sustained because
 - individuals are likely to interact *repeatedly*
 - cooperation (and defection) may be *reciprocated*
 - individuals can employ informal *monitoring* and *punishment*
- In **large groups**, this is more difficult
 - many interactions are not repeated
 - individual behavior has little effect on overall level of cooperation
 - little incentive to monitor and punish others

The protective state

- In addition to contractual terms, individuals may agree on an *enforcement institution*.
- Establishing an enforcer changes the post-constitutional game by reducing the payoff to defection.

		B	
		Respect Rights	Defect (steal)
A	Respect Rights	19,7	3,11- 5
	Defect (steal)	22- 5 ,1	9,2

- This makes it *individually rational* to comply with the terms of a constitutional contract *ex post*, in the post-constitutional phase.

The protective state

- Voluntarily installed *enforcement* institution
- *Agent* of parties to the constitutional contract.
- Commitment device: ensures post-constitutional interests = constitutional interests.



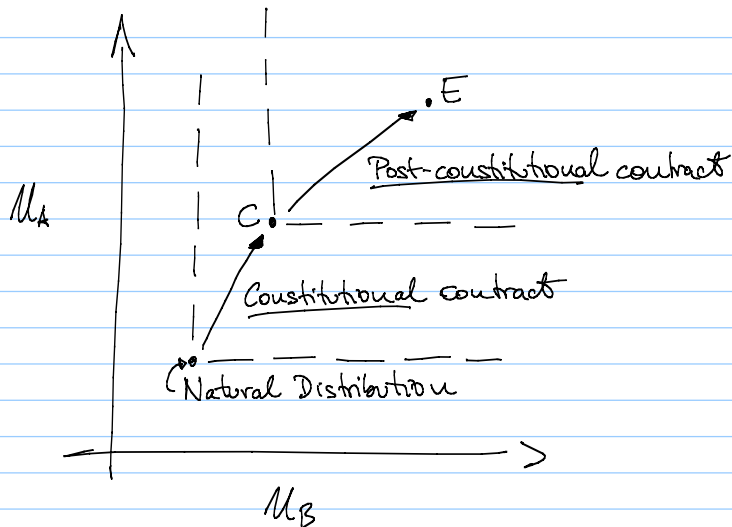
- **Note:** The protective state is *not* empowered to make *decisions* that modify the allocation of resources. It merely enforces the constitutional agreement. (So far, a specific allocation of X)

Private goods and post-constitutional contracts

- Suppose there are *multiple* private goods (X and Y)
- Again, attack and defense activities lead to a 'Natural Distribution'
- The *constitutional contract* establishes property rights and allows parties to reduce attack / defense efforts.
- Since there are multiple goods, additional *gains from trade* may become possible in the future.

Post-constitutional exchange

- The constitutional contract may therefore specify that *post-constitutional* contracts can be established by *mutual consent*.
- The protective state is empowered to enforce the terms of such contracts.
- **Important point:** This too does not require the state to make decisions concerning the allocation of resources - only to make 'factual' determinations concerning the terms of contracts.



Public goods

- Public good Z produced using X and / or Y as inputs.
- Further 'trades' (voluntary agreements to purchase or produce Z) may be possible, at least in principle.
- According to the constitutional rules established to this point, the protective state could *enforce* such agreements.
- But: Voluntary agreements to provide public goods may be difficult to establish, especially in large groups (see previous lecture).
 - All contributing parties would have to agree.
 - Incentives to 'free ride' on others' willingness to participate.
 - A 'Coasian bargain' is possible in principle but costly to organize.

Implication

- If individuals establish only a protective state (enforcing *property rights* and *mutual agreements*), some Pareto improving agreements (e.g. to provide public goods) may not be realized.
- Therefore individuals may wish, in addition, to establish an institution that is authorized to provide public goods and to *force* individuals to contribute *without* their consent.

The productive state

- The 'productive state' is created to provide public goods that would not be provided 'voluntarily' (i.e. via private agreements).
- It follows that the productive state must be authorized to *coerce* individuals into contributing without securing their (unanimous) consent.
- Unlike the protective state, which simply *enforces* contracts that are unanimously agreed upon, the **protective** state must be authorized to make *decisions*.
 - Legislative power (in addition to judicial, executive)
- In order for this to make a difference, **the 'productive state' must be authorized to make decisions using some *non-unanimous* decision rule.**

Decision rules for post-constitutional public goods trade

- What decision rule should the 'productive state' use?
- Buchanan and Tullock (1965) analyze this question from the perspective of rational individuals.
- We can interpret these individuals as members of a constitutional convention, or of a body considering constitutional reforms.
- B&T suggests that a 'representative individual' should consider two kinds of expected *costs*:
 - (a) Costs of adverse (post-constitutional) decisions ('external costs')
 - (b) Costs of (post-constitutional) decision making itself ('decision costs')
- For simplicity, restrict attention to q -majority rules.
 - A proposal / contract is approved and becomes binding if at least q of n members agree.

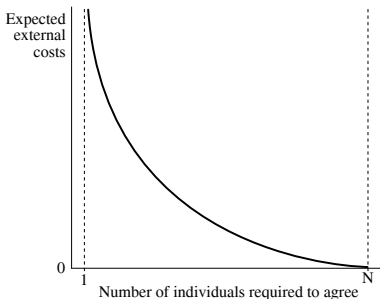
External costs

Less-than-unanimity rules

- others may take decisions which harm an individual
- -> positive external costs expected
- 'any one' rule maximizes costs

Unanimity rule

- Any individual can veto any adverse decisions
- -> no external costs can be imposed



Decision costs

- Suppose a **Pareto improving** post-constitutional trade is possible.
- In principle, the group can achieve unanimous consent, but...
 - Literal unanimous consent may be *logistically* impossible / prohibitively costly to secure.
 - Unanimity rule may create *strategic* incentives to 'hold out'
 - 'Pretending' to be opposed.
 - Demanding 'payment' for consent.
 - Excessive haggling.

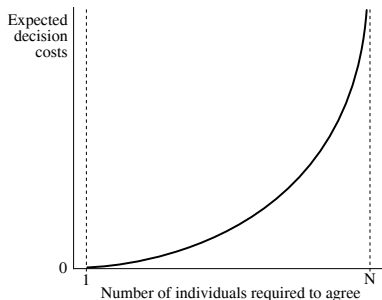
Decision costs

Less-than-unanimity rules

- any individual can be replaced
- reduces incentives to bargain
- -> lower decision costs
- “any one” rule minimizes costs

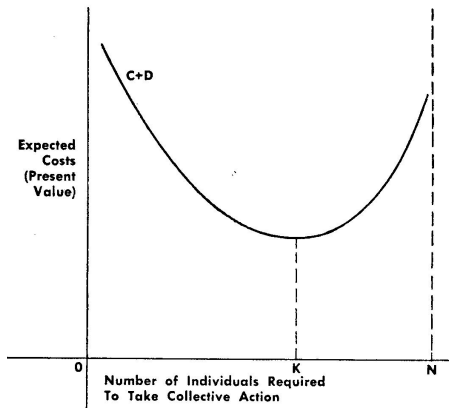
Unanimity rule

- each individual has veto power
- maximizes incentives to bargain
- -> maximizes decision costs



Optimal decision rule

- Minimizes the *sum* of external and decision costs



Discussion

- The tradeoff between expected decision costs and external costs is likely to differ depending on the type of decision (e.g. the type of public good) being considered.
- Individuals may agree to use different rules for different *categories* of post-constitutional contracts.
- What kinds of rules would you consider appropriate for these categories of decisions?
 - (1) Decisions to provide public goods financed by equal tax imposed on all members.
 - (2) Redistributive policies (transfer payments, subsidies) that benefit some at the expense of others.
- (How) does your preferred decision rule depend on the method of taxation permissible for financing public goods?
- (How) does your preferred decision rule vary with the 'scope' of government power (resp. constraints) more generally?

Summary

- Post-constitutional *private goods* trades can be conducted using the principle of mutual (unanimous) consent. No institutions for 'collective' decision making are needed. (Protective state)
- Pareto improving *public goods* trades can *conceptually* secure unanimous approval. However, requiring unanimous consent may imply prohibitive decision making costs.
- Individuals may *unanimously* agree, at the constitutional stage, to use *less-than-unanimity rules* (= democratic institutions) for *some* post-constitutional 'contracts'. (Productive state)
- **If less inclusive decision rules ($q < n$) are to be used, individuals will wish to place *limits* on the decisions that can be made.**
- A constitution that achieves **unanimous agreement** is likely to specify
 - *categories* of activities to be organized collectively.
 - *decision rules* to be used for each category.
 - *restrictions* on collective actions that can be initiated using a given rule.

Fundamental conclusions:

- Sovereign individuals may unanimously agree to establish a *protective state*
 - Coercion is used (only) to ensure respect of property rights and compliance with voluntary (constitutional and post-constitutional) agreements.
- *In addition*, may agree to establish a *productive state*
 - Coercion is used to enforce 'collective' decisions made using less-than-unanimity rules, i.e. *without* the consent of all affected.
- The legitimizing principle is **unanimous consent at the constitutional stage**: Agreement on *rules* rather than specific government *actions*.
- Legitimate government, in this view, requires
 - 'Default' respect for private property and contracts.
 - Rules concerning how collective decisions are to be made.
 - **Rules *constraining* the types of collective actions which can be initiated through non-unanimous decision rules.**

Criticisms of social contract theory

- How does this perspective help to judge existing political institutions?
- How are we to interpret the fundamental criterion of agreement?
 - *Historical* agreement to an 'original' contract?
 - *Ongoing* (implicit) agreement to an *existing* contract?
 - Possible / conceivable agreement to a *hypothetical* contract?
- Each of these interpretations has been criticized - most famously by David Hume (see readings)
 - Few (if any) political regimes can be traced back to an *original contract*. Even if an original contract was agreed to, it is not clear why it should be binding for later generations who are born into society as it exists today.
 - The concept of *implicit agreement* is limited by the fact that exit from an existing regime may be very costly.
 - *Hypothetically*, it is possible to justify many different political regimes (Hobbes: Absolutism; Rousseau: Rule of the 'general will'; Locke, Buchanan: Limited government)

Literature

(* = required)

(*) BUCHANAN, J. 1975. *The Limits of Liberty: Between Anarchy and Leviathan*. CHAPTERS 3 and 4 (available online at www.econlib.org)

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