# The Constitution of Economic Policy

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The science of public finance should always keep . . . political conditions clearly in mind. Instead of expecting guidance from a doctrine of taxation that is based on the political philosophy of by-gone ages, it should instead endeavor to unlock the mysteries of the spirit of progress and development. [Wicksell (*1*, p. 87)]

MANY OF MY CONTRIBUTIONS, AND ESPECIALLY THOSE IN political economy and fiscal theory, might be described as varied reiterations, elaborations, and extensions of themes first elaborated by Knut Wicksell. Stripped to its essentials, Wicksell's message was clear, elementary, and self-evident: economists should cease proffering policy advice as if they were employed by a benevolent despot, and they should look to the structure within which political decisions are made. Armed with Wicksell, I, too, could dare to challenge the still-dominant orthodoxy in public finance and welfare economics. In a preliminary paper (*2*) I called upon my fellow economists to postulate some model of the state, of politics, before proceeding to analyze the effects of alternative policy measures. I urged economists to look at the "constitution of economic policy," to examine the rules, the constraints within which political agents act. Like Wicksell, my purpose was ultimately normative rather than antiseptically scientific. I sought to make economic sense out of the relationship between the individual and the state before proceeding to advance policy nostrums.

Wicksell deserves the designation as the most important precursor of modern public choice theory because we find, in his 1896 dissertation, all three of the constitutive elements that provide the foundations of this theory: methodological individualism, *Homo economicus*, and politics-as-exchange. I shall discuss these elements of analytical structure in the sections that follow and integrate them in a theory of economic policy. This theory is consistent with, builds upon, and systematically extends the traditionally accepted principles of Western liberal societies. The implied approach to institutional-constitutional reform continues, however, to be stubbornly resisted almost a century after Wicksell's seminal efforts. The individual's relation to the state, is, of course, the central subject matter of political philosophy. Any effort by economists to shed light on this relationship must be placed within this more comprehensive realm of discourse.

## Methodological Individualism

If utility is zero for each individual member of the community, the total utility for the community cannot be other than zero. [Wicksell (*1*, p. 77)]

The economist rarely examines the presuppositions of the models with which he works. The economist simply commences with individuals as evaluating, choosing, and acting units. Regardless of the possible complexity of the processes or institutional structures from which outcomes emerge, the economist focuses on individual choices. In application to market or private-sector interactions, this procedure is seldom challenged. Individuals, as buyers and sellers of ordinary (legally tradable) goods and services are presumed able to choose in accordance with their own preferences, whatever these may be, and the economist does not feel himself obliged to inquire deeply into the content of these preferences (the arguments in individuals' utility functions). Individuals themselves are the sources of evaluation, and the economist's task is to offer an explanation or understanding of the process through which these unexamined preferences are ultimately translated into a complex outcome pattern.

The 18th-century discovery that, in an institutional framework that facilitates voluntary exchanges among individuals, this process generates results that might be evaluated positively, produced "economics," as an independent academic discipline or science. The relation between the positively valued results of market processes and the institutional characteristics of these processes themselves emerged as a source of ambiguity when "the market" came to be interpreted functionally, as if something called "the economy" existed for the purpose of value maximization. Efficiency in the allocation of resources came to be defined independently of the processes through which individual choices are exercised.

Given this subtle shift toward a teleological interpretation of the economic process, it is not surprising that politics, or governmental process, was similarly interpreted. Furthermore, a teleological interpretation of politics had been, for centuries, the dominating thrust of political theory and political philosophy. The interpretations of "the economy" and "the polity" seemed, therefore, to be mutually compatible in the absence of inquiry into the fundamental difference in the point of evaluation. There was a failure to recognize that individuals who choose and act in the market generate outcomes that, under the specified constraints, can be judged to be value-maximizing for participating individuals, without the necessity of introducing an external evaluative criterion. The nature of the process itself ensures that individual values are maximized. This "value maximization" perspective cannot be extended from the market to politics since the latter does not directly embody the incentive compatible structure of the former. There is no political counterpart to Adam Smith's invisible hand. It is not, therefore, surprising that the attempt by Wicksell and other continental European scholars to extend economic theory to the operation of the public sector remained undeveloped for so many years.

An economic theory that remains essentially individualistic need not have become trapped in such a methodological straitjacket. If the maximization exercise is restricted to explanation or understanding of the individual who makes choices, and without extension to the economy as an aggregation, there is no difficulty at all in analyzing individual choice behavior under differing institutional


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settings and in predicting how these varying settings will influence the outcomes of the interaction processes. The individual who chooses between apples and oranges remains the same person who chooses between the levers marked "Candidate A" and "Candidate B" in the polling booth. Clearly, the differing institutional structures may, themselves, affect choice behavior. Much of modern public choice theory explains these relationships. But my point here is the more basic one to the effect that the choice behavior of the individual is equally subject to the application of analysis in all choice environments. Comparative analysis should allow for predictions of possible differences in the characteristics of the results that emerge from market and political structures of interaction. These predictions, as well as the analysis from which they are generated, are totally devoid of normative content.

## *Homo economicus*

> . . . [N]either the executive nor the legislative body, and even less the deciding majority in the latter, are in reality . . . what the ruling theory tells us they should be. They are not pure organs of the community with no thought other than to promote the common weal.
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> . . . [M]embers of the representative body are, in the overwhelming majority of cases, precisely as interested in the general welfare as are their constituents, neither more nor less. [Wicksell (*1*, pp. 86 and 87)]

This analysis can yield a limited set of potentially falsifiable hypotheses without prior specification of the arguments in individual utility functions. If, however, predictions are sought concerning the effects of shifts in constraints on choice behavior, some identification and signing of these arguments must be made. With this step, more extensive falsifiable propositions may be advanced. For example, if both apples and oranges are positively valued "goods," then, if the price of apples falls relative to that of oranges, more apples will be purchased relative to oranges; if income is a positively valued "good," and, then, if the marginal rate of tax on income source A increases relative to that on income source B, more effort at earning income will be shifted to source B; if charitable giving is a positively valued "good," then, if charitable gifts are made tax deductible, more giving will be predicted to occur; if pecuniary rents are positively valued, then, if a political agent's discretionary power to distribute rents increases, individuals hoping to secure these rents will invest more resources in attempts to influence the agent's decisions. Note that the identification and signing of the arguments in the utility functions takes us a considerable way toward operationalization without prior specification of the relative weights of the separate arguments. There is no need to assign net wealth or net income a dominating motivational influence on behavior in order to produce a fully operational economic theory of choice behavior, in market or political interaction.

In any extension of the model of individual rational behavior to politics, this difference between the identification and signing of arguments on the one hand and the weighting of these arguments on the other deserves further attention. Many critics of the "economic theory of politics" base their criticisms on the presumption that such theory necessarily embodies the hypothesis of net wealth maximization, an hypothesis that they observe to be falsified in many situations. Overly zealous users of this theory may have sometimes offered grounds for such misinterpretation on the part of critics. The minimal critical assumption for the explanatory power of the economic theory of politics is only that identifiable economic self-interest (for example, net wealth, income, social position) is a positively valued "good" to the individual who chooses. This assumption does not place economic interest in a dominating position and it surely does not imply imputing evil or malicious motives to political actors; in this respect the theory remains on all fours with the motivational structure of the standard economic theory of market behavior. The differences in the predicted results stemming from market and political interaction stem from differences in the structures of these two institutional settings rather than from any switch in the motives of persons as they move between institutional roles.

## Politics as Exchange

> It would seem to be a blatant injustice if someone should be forced to contribute toward the costs of some activity which does not further his interests or may even be diametrically opposed to them. [Wicksell (*1*, p. 89)]

Individuals choose, and as they do so, identifiable economic interest is one of the "goods" that they value positively, whether behavior takes place in markets or in politics. But markets are institutions of exchange; persons enter markets to exchange one thing for another. They do not enter markets to further some supra-exchange or supraindividualistic result. Markets are not motivationally functional; there is no conscious sense on the part of individual choosers that some preferred aggregate outcome, some overall "allocation" or "distribution" will emerge from the process.

The extension of this exchange conceptualization to politics counters the classical prejudice that persons participate in politics through some common search for the good, the true, and the beautiful, with these ideals being defined independently of the values of the participants as these might or might not be expressed by behavior. Politics, in this vision of political philosophy, is instrumental to the furtherance of these larger goals.

Wicksell, who is followed in this respect by modern public choice theorists, would have none of this. The relevant difference between markets and politics does not lie in the kinds of values or interests that persons pursue, but in the conditions under which they pursue their various interests. Politics is a structure of complex exchange among individuals, a structure within which persons seek to secure collectively their own privately defined objectives that cannot be efficiently secured through simple market exchanges. In the absence of individual interest, there is no interest. In the market, individuals exchange apples for oranges; in politics, individuals exchange agreed-on shares in contributions toward the costs of that which is commonly desired, from the services of the local fire station to that of the judge.

This ultimately voluntary basis for political agreement also counters the emphasis on politics as power that characterizes much modern analysis. The observed presence of coercive elements in the activity of the state seems difficult to reconcile with the model of voluntary exchange among individuals. We may, however, ask: Coercion to what purpose? Why must individuals subject themselves to the coercion inherent in collective action? The answer is evident. Individuals acquiesce in the coercion of the state, of politics, only if the ultimate constitutional "exchange" furthers their interests. Without some model of exchange, no coercion of the individual by the state is consistent with the individualistic value norm upon which a liberal social order is grounded.

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> . . . [W]hether the benefits of the proposed activity to the individual citizens would be greater than its cost to them, no one can judge this better than the individuals themselves. [Wicksell (*1*, p. 79)]

The exchange conceptualization of politics is important in the derivation of a normative theory of economic policy. Improvement in the workings of politics is measured in terms of the satisfaction of that which is desired by individuals, whatever this may be, rather than in terms of moving closer to some externally defined, supra-individualistic ideal. That which is desired by individuals may, of course, be common for many persons, and, indeed, the difference between market exchange and political exchange lies in the sharing of objectives in the latter. The idealized agreement on the objectives of politics does not, however, allow for any supersession of individual evaluation. Agreement itself emerges, again conceptually, from the revealed choice behavior of individuals. Commonly shared agreement must be carefully distinguished from any externally defined definition or description of that "good" upon which persons "should agree."

The restrictive implications for a normative theory of economic policy are severe. There is no criterion through which policy may be directly evaluated. An indirect evaluation may be based on some measure of the degree to which the political process facilitates the translation of expressed individual preferences into observed political outcomes. The focus of evaluative attention becomes the process itself, as contrasted with end-state or outcome patterns. "Improvement" must, therefore, be sought in reforms in process, in institutional change that will allow the operation of politics to mirror more accurately that set of results that are preferred by those who participate. One way of stating the difference between the Wicksellian approach and that which is still orthodoxy in normative economics is to say that the constitution of policy rather than policy itself becomes the relevant object for reform. A simple game analogy illustrates the difference here. The Wicksellian approach concentrates on reform in the rules, which may be in the potential interest of all players, as opposed to improvement in strategies of play for particular players within defined or existing rules.

In the standard theory of choice in markets, there is little or no concern with the constitution of the choice environment. We simply presume that the individual is able to implement his preferences; if he wants to purchase an orange, we presume that he can do so. There is no institutional barrier between the revealed expression of preference and direct satisfaction. Breakdown or failure in the market emerges, not in the translation of individual preferences into outcomes, but in the possible presentation of some choosers with alternatives that do not correspond to those faced by others in the exchange nexus. "Efficiency" in market interaction is ensured if the participants are faced with the same choice options.

In political exchange, there is no decentralized process that allows "efficiency" to be evaluated deontologically, akin to the evaluation of a market. Individuals cannot, by the nature of the goods that are collectively "purchased" in politics, adjust their own behavior to common terms of trade. The political analogue to decentralized trading among individuals must be that feature common over all exchanges, which is agreement among the individuals who participate. The unanimity rule for collective choice is the political analogue to freedom of exchange of partitionable goods in markets.

It is possible, therefore, to evaluate politics independently of results only by ascertaining the degree of correspondence between the rules of reaching decisions and the unique rule that would guarantee "efficiency," that of unanimity or agreement among all participants. If, then, "efficiency" is acknowledged to be the desired criterion, again as interpreted here, normative improvement in process is measured by movement toward the unanimity requirement. It is perhaps useful to note, at this point, that Wicksell's own characterization of his proposals in terms of "justice" rather than "efficiency" suggests the precise correspondence of these two norms in the context of voluntary exchange.

Politics as observed remains, of course, far from the idealized collective-cooperative exchange that the unanimity rule would implement. The political equivalent to transactions cost makes the pursuit of idealized "efficiency" seem even more out of the bounds of reason than the analogous pursuit in markets. But barriers to realization of the ideal do not imply rejection of the benchmark definition of the ideal itself. Instead, such barriers are themselves incorporated into a generalized "calculus of consent."

Wicksell himself did not go beyond advocacy of reform in legislative decision structures. He proposed a required linking of spending and financing decisions, and he proposed that a quasi-unanimity rule be introduced for noncommitted outlays. Wicksell did not consciously extend his analysis to constitutional choice, to the choice of the rules within which ordinary politics is to be allowed to operate. His suggested reforms were, of course, constitutional, since they were aimed to improve the process of decision-making. But his evaluative criterion was restricted to the matching of individual preferences with political outcomes in particularized decisions, rather than over any sequence.

It is perhaps worth noting that Wicksell himself did not look upon his suggested procedural reforms as restrictive. By introducing greater flexibility into the tax-share structure, Wicksell predicted the potential approval of spending programs that would continue to be rejected under rigid taxing arrangements. Critics have, however, interpreted the Wicksellian unanimity constraint to be restrictive, and especially as compared to the extended activity observed in ordinary politics. This restrictive interpretation was perhaps partially responsible for the continued failure of political economists to recognize his seminal extension of the efficiency norm to the political sector. Such restrictiveness is very substantially reduced, and, in the limit, may be altogether eliminated, when the unanimity criterion is shifted one stage upward, to the level of potential agreement on constitutional rules within which ordinary politics is to be allowed to operate. In this framework, an individual may rationally prefer a rule that will, on particular occasions, operate to produce results that are opposed to his own interests. The individual will do so if he predicts that, on balance over the whole sequence of "plays," his own interests will be more effectively served than by the more restrictive application of the Wicksellian requirement in-period. The in-period Wicksellian criterion remains valid as a measure of the particularized efficiency of the single decision examined. But the in-period violation of the criterion does not imply the inefficiency of the rule so long as the latter is itself selected by a constitutional rule of unanimity (*3*).

As noted, the shift of the Wicksellian criterion to the constitutional stage of choice among rules also serves to facilitate agreement and, in the limiting case, may remove altogether potential conflicts among separate individual and group interests. To the extent that the individual reckons that a constitutional rule will remain applicable over a long sequence of periods, with many in-period choices to be made, he is necessarily placed behind a partial "veil of uncertainty" concerning the effects of any rule on his own predicted interests. Choice among rules will, therefore, tend to be based on generalizable criteria of fairness, making agreement more likely to occur than when separable interests are more easily identifiable.

The political economist who operates from within the Wicksellian research program, as modified, and who seeks to offer normative advice must, of necessity, concentrate on the process or structure within which political decisions are observed to be made. Existing constitutions, or structures of rules, are the subject of critical scrutiny. The conjectural question becomes, "Could these rules have emerged from agreement by participants in an authentic constitutional convention?" Even here, the normative advice that is possible must be severely circumscribed. There is no external set of norms that provides a basis for criticism. But the potential economist may, cautiously, suggest changes in procedures, in rules, that may come to command general assent. Any suggested change must be offered only in the provisional sense and, importantly, it must be accompanied by a responsible recognition of political reality. Those rules and rules changes worthy of consideration are those that are predicted to be workable within the politics inhabited by ordinary men and women and not those that are appropriate only for idealized, omniscient, and benevolent beings. Policy options must remain within the realm of the feasible, and the interests of political agents must be recognized as constraints on the possible.

## Constitutionalism and Contractarianism

> The ultimate goal . . . is equality before the law, greatest possible liberty, and the economic well-being and peaceful cooperation of all people. [Wicksell (*1*, p. 88)]

As the basic Wicksellian construction is shifted to the choice among rules or constitutions and as a veil of uncertainty is used to facilitate the potential bridging of the difference between identifiable and general interest, the research program in political economy merges into that of contractarian political philosophy, both in its classical and modern variations. In particular, my own approach has affinities with the familiar construction of Rawls (*4*) who used the veil of ignorance along with the fairness criterion to derive principles of justice that emerge from a conceptual agreement at a stage prior to the selection of a political constitution.

Because of his failure to shift his own analytical construction to the level of constitutional choice, Wicksell was confined to evaluation of the political process in generating current allocative decisions. He was unable, as he quite explicitly acknowledged, to evaluate political action involving either prior commitments of the state, for example, the financing of interest on public debt, or fiscally implemented transfers of incomes and wealth among persons and groups. Distributional questions remain outside the Wicksellian evaluative exercise, and because they do so, we locate another source of the long-continued and curious neglect of the fundamental analytical contribution. With the shift to the constitutional stage of politics, however, this constraint is at least partially removed. Behind a sufficiently thick veil of uncertainty, ignorance, or both, contractual agreement on rules that allow for some in-period fiscal transfers seems to be possible. The precise features of a constitutionally approved transfer structure cannot, of course, be derived independently because of the restriction of evaluative judgment to the process of constitutional agreement. In this respect, the application is fully analogous to Wicksell's unwillingness to lay down specific norms for tax sharing independently of the process of agreement. Any distribution of tax shares generating revenues sufficient to finance the relevant spending project passes Wicksell's test, provided only that it meets with general agreement. Analogously, any set of arrangements for implementing fiscal transfers, in-period, meets the constitutional stage Wicksellian test, provided only that it commands general agreement.

This basic indeterminacy is disturbing to political economists or philosophers who seek to be able to offer substantive advice over and beyond the procedural limits suggested. The constructivist urge to assume a role as social engineer, to suggest policy reforms that should or should not be made, independently of any revelation of individuals' preferences through the political process, has simply proved too strong for many to resist. The scientific integrity dictated by consistent reliance on individualistic values has not been a mark of modern political economy.

The difficulty of maintaining such integrity is accentuated by the failure to distinguish explanatory and justificatory argument, a failure that has described the position of almost all critics of social contract theories of political order. We do not, of course, observe the process of reaching agreement on constitutional rules, and the origins of the rules that are in existence at any particular time and in any particular polity cannot satisfactorily be explained by the contractarian model. The purpose of the contractarian exercise is not explanatory in this sense. It is, by contrast, justificatory in that it offers a basis for normative evaluation. Could the observed rules that constrain the activity of ordinary politics have emerged from agreement in constitutional contract? To the extent that this question can be affirmatively answered we have established a legitimating linkage between the individual and the state. To the extent that the question prompts a negative response, we have a basis for normative criticism of the existing order, and a criterion for advancing proposals for constitutional reform (*5*).

It is at this point, and this point only, that the political economist who seeks to remain within the normative constraints imposed by the individualistic canon may enter the dialogue on constitutional policy. The deficit-financing regimes in modern Western democratic polities offer the most dramatic example. It is almost impossible to construct a contractual calculus in which representatives of separate generations would agree to allow majorities in a single generation to finance currently enjoyed public consumption through the issue of public debt that ensures the imposition of utility losses on later generations of taxpayers. The same conclusion applies to the implicit debt obligations that are reflected in many of the intergenerational transfer programs characteristic of the modern welfare state.

The whole contractarian exercise remains empty if the critical dependence of politically generated results upon the rules that constrain political action is denied. If end states are invariant over shifts in constitutional structure, there is no role for constitutional political economy. On the other hand, if institutions do, indeed, matter, the role is well defined. Positively, this role involves analysis of the working properties of alternative sets of constraining rules. In a game theoretic analogy, this analysis is the search for solutions of games, as the latter are defined by sets of rules. Normatively, the task for the constitutional political economist is to assist individuals, as citizens who ultimately control their own social order, in their continuing search for those rules of the political game that will best serve their purposes, whatever these might be.

In 1987, the United States celebrates the bicentennial anniversary of the constitutional convention that provided the basic rules for the political order in the United States. This convention was one of the few historical examples in which political rules were deliberately chosen. The vision of politics that informed the thinking of James Madison was not dissimilar, in its essentials, from that which informed Knut Wicksell's less comprehensive, but more focused, analysis of taxation and spending. Both rejected any organic conception of the state as superior in wisdom to the individuals who are its members. Both sought to bring all available scientific analysis to bear in helping to resolve the continuing question of social order. How can we live together in peace, prosperity, and harmony, while retaining our liberties as autonomous individuals who can, and must, create our own values?

### REFERENCES AND NOTES


1. This and subsequent citations are from K. Wicksell, in *Classics in the Theory of Public Finance*, R. A. Musgrave and A. T. Peacock, Eds. (Macmillan, London, 1958), pp. 72–118. The more inclusive work from which this translated essay is taken is K. Wicksell, *Finanztheoretische Untersuchungen* (Fischer, Jena, 1896).
2. J. M. Buchanan, *J. Polit. Econ.* 57, 496 (1949).
3. In my own retrospective interpretation, the shift of the Wicksellian construction to the constitutional stage of choice was the most important contribution [J. M. Buchanan and G. Tullock, *The Calculus of Consent* (Univ. of Michigan Press, Ann Arbor, 1962)].
4. J. Rawls, *A Theory of Justice* (Harvard Univ. Press, Cambridge, MA, 1971).
5. A generalized argument for adopting the constitutionalist-contractarian perspective, in both positive and normative analysis, is developed by G. Brennan and J. M. Buchanan [*The Reason of Rules* (Cambridge Univ. Press, Cambridge, 1985)].


6. I am indebted to R. Tollison, V. Vanberg, and R. Wagner for helpful comments.