

# Chapter 11: Ethics and Constitutional Political Economy

**The essence of Government is power; and power, lodged as it must be in human hands, will ever be liable to abuse.** (James Madison [1829], “Speech at the Virginia Constitutional Convention” in Galliard Hunt [Ed.], *The Writings of James Madison: 1819–1836* [1910], p. 361 [KL 4548], New York, NY: G. P. Putnam’s Sons)

**Public choice theory has been the avenue through which a romantic and illusory set of notions about the workings of governments and the behavior of persons who govern has been replaced by a set of notions that embody more skepticism about what governments can do** and governors will do...public choice offers a theory of governmental failure that is fully comparable to the theory of market failure that emerged from the theoretical welfare economics of the 1930s and 1940s. (James Buchanan [1984], “Politics without Romance” in J. M. Buchanan and R. D. Tollison [Eds.], *The Theory of Public Choice II*, Ann Arbor, MI: University of Michigan Press)

## I. Introduction: Governance, Ethics, and the Legal Setting for Commerce

Welfare economists, as noted in the previous chapter, often argue that targeted taxes, regulations, and expenditures can reduce externality and public goods problems. In addition, redistribution may increase welfare by generating more utility for the poor than lost by the rich. Similar arguments can also be grounded in utilitarian and contractarian logic.

Such conclusions—and the many other regulatory and anti-regulatory proponents of previous centuries—imply that economic development is at least partly a matter of politics. Tax law, regulatory law, and civil law are all ultimately products of governments and all have a variety of direct

and indirect effects on economic development. Such effects include direct ones on transactions cost and freedom to enter various markets as with licensing, tariffs, and grants of monopoly. They also include indirect effects on civil ethics that encourage or discourage investments in commerce supporting ethical dispositions, as noted by Aristotle and La Court. Without appropriate government policies and governance, a commercial society is unlikely to emerge.

This chapter explores the extent to which public policies and governmental institutions are partly consequences of internalized ethical dispositions of law makers and the citizenry. The analysis relies on extended rational choice models of citizens and government officeholders, as in the previous analysis of commerce itself. As developed below, the analysis implies that ethical dispositions and other norms partly determine the political institutions through which policies are adopted, the policies chosen, and their manner of implementation. They therefore also affect conclusions about where best to draw the line between private autonomy and community regulation.

### A. Ethics and the Effectiveness of Governing Organizations

These principalities are liable to danger when they are passing from the civil to the absolute order of government, for such princes either rule personally or through magistrates. In the latter case their government is weaker and more insecure, because it rests entirely on the goodwill of those citizens who are raised to the magistracy, and who, especially in troubled times, can destroy the government with great ease, either by intrigue or open defiance. [Machiavelli, N. (1513/2015) *The Prince*. (Wisepress Classics Edition) (KL 751-754)].

Governments are in many ways similar to economic firms. They are organizations. They benefit from team production and specialization. They have internal rules for team members. They differ in that governments can impose rules on persons outside their organization. Governments can do so because of one of the outputs of their teams is the production of coercive force. They can literally force persons in their territories to obey the laws imposed. Those known to have violated their rules may

lose their property, freedom, or life. It is the threat of such punishments that accounts for their ability to impose tax, civil, and regulatory laws on persons within the territories governed.

However, the moral foundations of many laws and the strength and nature of the internalized ethical dispositions of a polity's citizenry determine how often and how much force will be required to do so. If the laws are consistent with the prevailing dispositions, little force will be required, because the citizenry will "naturally" tend to obey the law. Such laws will be followed because the internalized ethical dispositions of the citizenry induce particular modes of conduct, rather than external threats from law enforcing agencies. The latter are only necessary because not all persons have internalized the relevant dispositions with sufficient strength to resist all temptations. When the moral and pragmatic interests of government policy makers are not well aligned with those of the citizens, far more threats will necessarily be required to induce law-following behavior on the part of the citizenry.

The effectiveness of the governing organization itself, like other organizations depends partly on its own rules and regulations, and partly on the internalized ethical disposition of its team members for reasons developed in part II. Government employees that are honest and have a strong work ethic will generate more output than those lacking them, other things being equal. It is clear, for example, that a government can produce more public goods with less labor if internalized dispositions increase the productivity of the teams producing those services. This is true of highway design, construction, and maintenance, but also of law enforcement, national defense, and legislation.

It bears noting, however, that the meaning of "effectiveness" is itself partly ethical. Effective means one thing to a utilitarian and quite another to a pragmatist. A pragmatic authoritarian regime arguably aims to maximize the net benefits of the top strata of government decision makers, rather than aggregate utility. A pragmatic democratic regime attempts to win majority approval for the top strata of government decisionmakers in the next election. The latter requires advancing relatively broad interests, but not maximizing aggregate utility.

The policies that best advance the goals of top officials under these two types of government differ, as does the meaning of the word effective for

the pragmatists and ethically motivated men and women who hold offices in those governments.

## **B. On the Limits of Institutionally Induced Interests**

The interests of government decision makers are partly personal ones held prior to taking government employment and partly induced by the reward and recruiting system of governments. Personal preferences include a person's natural demands for primary goods, such as food, shelter, and romance. They also include what might be called culturally induced demands, including variety of norms and private ethical dispositions. These are the interests that the people employed in government would have had whether they worked for the government or not.<sup>1</sup>

Institutionally induced preferences, in contrast, are ones associated with specific positions and organization. They reflect the recruiting and reward systems of the organizations in which they are or have been employed. Some types of behavior are rewarded with promotion and salaries and others are not. Institutionally induced preferences also reflect, at least partially, the efforts of governmental organizations to induce particular internalized norms and duties within the persons selected for government positions.

A good deal of the behavior of individuals holding positions within an organization is induced by the organization's formal and informal systems of rewards. Most of these, however, rely upon personal interests for their effects. For example, college professors publish articles and books because this brings rewards in the form of tenure, salary increase and status within their colleges and academic organizations. Very few would work so hard at their research were it not directly and indirectly reward-

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<sup>1</sup> Aristotle and Adam Smith, for example, both argue that ethical dispositions are learned through a combination of teaching, personal experience, and reflection. The first two are aspects of the culture in which a person comes to adulthood in. To the extent that a small subset of ethical dispositions or capacities for such dispositions are genetically transmitted, some aspects of personal ethics might be largely independent of culture, although even in these cases the moral dilemmas faced and lessons learned would reflect day-to-day experience and reflection.

ed. Other organizations reward different activities, but the effects are similar. These too tend to produce habits of thought and action, and in many cases a sense of duty similar to that associated with one's ethical dispositions. Habits of thought and conduct that tend to bring more approval and esteem, larger salaries, and increase status all tend to advance an employee's personal interests.

However, external reward systems are insufficiently fine-grained and omnipresent to induce all the behavior that is likely to advance organizational ends. Nor do these systems create "organizational men and women," who lose all sense of their former selves. An employee's preexisting nature and internalized dispositions are thus also important. Voters and other recruiters thus take skills and a variety of ethical dispositions into account when selecting persons for particular tasks within government. Such choices reflect subjective assessments about future behavior in the complex circumstances they are likely to face.

Can a person perform the main tasks associated with a particular position? Is that person likely to do so given the incentive structure of the organization? Can a person be trusted to make good decisions in unusual circumstances beyond those incentivized by external rewards? Will he or she tend to follow rules or not, get along with fellow employees, aspire to be the best that he or she can be or not, innovate, or not? Answers to all but the first question are largely determined by the internalized ethical dispositions and other norms of the persons under consideration.

### **C. Ethics and Agency Costs Within Governments**

All large organizations confront a variety of agency problems that have to be overcome if they are to effectively advance organizational aims, whether the aim is profits, votes, public service, or the welfare of the most powerful government officials. Employees rarely have personal interests that are perfectly aligned with those of their employers. Their organization's recruiting and reward systems attempt to improve the alignment, but rarely do so perfectly. Thus, employees fail to fully discharge their organizational duties, which tends to reduce every organization's effectiveness from the perspective of their principals: firm owners, voters, prime minister, royal families, etc.

Such agency problems tend to be more severe for governments than for most other organizations for two reasons. First, the productivity of

government employees and agencies is often more difficult to assess than employees in private organizations. There is rarely an obvious index that can be used to determine the productivity of government employees or agencies in the manner that money profits can be used for economic organizations. Shirking problems also exist within private organizations, but private measurement problems tend to be somewhat smaller, more objective, and so more manageable. Second, there is a type of agency problem that tends to have greater effects on persons living in a community when manifested by government officials than by persons within non-governmental organizations, namely the problem of the abuse of authority.

Abuse of authority problems does not necessarily affect the magnitude of an organization's output, but rather what output is produced, how it is produced, and how it is used. In private firms, for example, a firm's "buyer" may purchase inputs from friends and family members or receive "kickbacks" from suppliers, rather than purchase them from the least-cost sources. Such abuses tend to increase production costs and somewhat reduce a firm's profits, although it may not affect total profits.<sup>2</sup> Similar abuses of authority in governments often involve larger contracts and so have larger effects on the distribution of profits among firms and income levels of government officials (through bribes and kickbacks).

Similarly, although even harder to measure, managers and executives may create or interpret rules in a manner favorable or unfavorable to third parties who are not members of their organization. The extent to which government officials may do so again tends to have greater impacts on the community than that by persons in non-governmental organizations. For example, some builders may face less stringent building codes than others, some firm owners may face less aggressive efforts to enforce tax laws than others, some firms may confront less stringent environmental laws than others. The result tends to be somewhat weaker

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<sup>2</sup> Total profits, however, may not be affected. Such transactions informally share the profits of production among the selling and buying firms, although often unintentionally, and not necessarily in a manner that would have been agreed to by firm owners or senior management. Such practices insofar as they are unobserved or unobservable can be reduced through sophisticated incentive compatible contracts or by hiring persons whose internalized ethical dispositions run counter to such practices.

buildings, lower tax revenues and environmental quality than formally required by law.

As in the private sector, the temptation to misuse authority in government organizations is often increased by tantalizing offers and persuasive arguments by groups outside their organization. Customers and suppliers often lobby private firms for changes in service hours, dress codes, offerings, environmental practices, and the like. However, their efforts tend to be smaller than those of contractors dealing with governmental projects, because their interests are also smaller. The average potential reward and loss tend to be greater in dealings with governmental agencies than with branches of even large private organizations. Thus, greater efforts are undertaken, and the temptations confronted by government employees and agencies tend to be greater than for their private counterparts.

Encouraging employees to resist such temptations when they run counter to organizational interests requires both active monitoring and self-monitoring, the latter being simply another term for internalized ethical dispositions.

## II. Ethics in Authoritarian Regimes

Beyond the generalized norms of all organizations, different forms of government tend to have their own supportive ethical systems and norms as emphasized by Montesquieu. For example, early authoritarian governments evidently emerged from organizations with the ability to intimidate persons within “their” territory with threats of violence. Such organizations evidently specialized in military arts and terror, and used those “outputs” to impose rules on others.

It might seem “obvious” that pragmatic extractive regimes would operate without rules or internalized ethical dispositions, but this is not the case. Rules in such governments would be adopted to advance the goals of the rule-making group. There will be rules for those outside the governing organization and rules for those inside. The dominant group might, for example, attempt to reduce all others in the community to slavery or serfdom in order to harvest the entire social surplus. The lives of most slaves and serfs are, of course, rule bound and often yield “in-

come” levels near the minimum at which humans remain productive. The rules imposed on members of the ruling organization also tend to advance their organization’s objectives. They support, for example, hierarchical deference and obedience. Such norms help legitimize the dominant positions of persons in leadership posts, which reduces internal conflict and improves coordination.

Beyond hierarchical rules, what might be called Spartan ethics are orientated toward a military life of coordinated attack and defensive strategies and subsequent control of those conquered.<sup>3</sup> Military organizations routinely promote virtues such as toughness, courage, and discipline through praise, esteem, medals, status, rank, and shares in the bounty. The fruits of victory should go to the clever, strong, and brave, who “naturally” tend to rise to the apex of authority in such organizations. The military theory of distributive justice includes such ideas as “to the victor go the spoils,” “power grows out of the barrel of a gun,” and “might makes right,” which applies to armies, nation states, and to individuals within such regimes.

Patterns of deference within military organizations are induced through the internalization of a variety of rules of conduct, many of which appear to be arbitrary such as various forms of saluting, rules for eye contact, bowing, and dress codes. These and other “arbitrary” rules promote the orderly deference required for medium and large scale military campaigns. The same norms are useful for governing territories controlled. Authoritarian organization composed of persons without such internalized norms would be less effective than ones with them and so less likely to emerge victorious in military contests.

Insofar as the aim of an authoritarian regime is power and plunder, the rules imposed on persons outside their governing organization tend to differ from those inside the ruling group. Many of the external laws extractive regimes will, for example, conflict with both utilitarian and contractarian theories of law and governance and from those perspectives would be regarded to be unethical, although they are consistent with the military ethos and advance the goals of the governing organization.

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<sup>3</sup> There are many book length treatments of this point. See, for example, Sherman (2007).

When slavery is not possible or less profitable than more open systems, despotic groups may adopt laws that promote economic development, because such laws ultimately provide them with greater wealth and power than the alternatives (Tullock 1972, Olson 2000). Such “stationary bandits” have what Olson (1965, 2000) terms an encompassing interest in the economic resources of their societies. Laws that promote economic development increase long-term expected revenues from taxation, rent extraction, and extortion.

Nonetheless, one rarely observes well-functioning markets in dictatorships. This is partly because the tenure of dictators is highly uncertain, which tends to induce many authoritarian rulers to live for today rather than plan for and invest in the future.<sup>4</sup> It is also partly because the support necessary to hold onto power is often produced through grants of special privileges to persons, families, and towns. Such privileged persons and towns are well aware that the need continued “protection” from the rulers for their privileges and so will support the central government and defend both its rules and authority. Anti-privileges may also be imposed on likely opponents. A ruling group is more likely to retain power if its opponents are poor rather than well financed.<sup>5</sup> Such legal systems reduce economic prosperity by reducing competition and blocking innovation from unfavored and disfavored individuals and organizations. Moreover, the unthinking deference to “authority” promoted by autocratic systems tends to undermine many of the virtues required for markets to flourish.<sup>6</sup>

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<sup>4</sup>See Bienen and van de Walle (1989) for evidence of high turnover among dictators in the twentieth century.

<sup>5</sup>See Tullock (1972) for a short exposition on this idea or Mesquita, Smith, Silverson, and Morrow (2003) for a more thorough development.

<sup>6</sup> Montesquie (1748, kl 543-565), argues that “Virtue is not the Principle of a Monarchical Government,” although he also he concedes in monarchies “[H]onour, ... supplies the place of the political virtue of which I have been speaking...” Nonetheless, “[P]erpetual ridicule cast upon virtue, are, I think, the characteristics by which most courtiers in all ages and countries have been constantly distinguished.”

Of course, it is possible that a dictator could be a utilitarian—one possible version of what Plato scholars term a philosopher king—but such instances are very rare historically, so rare that they are beyond the scope of this chapter. That the commercial society emerged from more or less democratic societies (and vice versa) is sufficient reason to focus the remainder of the chapter on the many roles that ethical dispositions play in democratic systems of government.

### III. Ethics and the Viability of Democracy

The emergence of a formal system of laws and law enforcement does not necessarily begin with a military organization, although they are often useful. A community government can also emerge informally as a consequence of agreements among persons to address shared problems, including threats from neighboring military regimes. The decisions reached may initially be enforced informally through praise, shame, and shared internalized ethical dispositions. Such informal rule-making and enforcement may gradually become formalized by create standing meeting times, procedures, and organizations for interpreting and enforcing their rulings.

Such participatory states or commonwealths may be quite stable and resilient. For example, in medieval Scandinavia, new rules and new interpretations of old laws were chosen via consensus or majority rule at informal local and regional assemblies called *tings*.<sup>7</sup> Similar open meetings of grand councils were common in England in the same period. Many early colonial towns and villages in the New England colonies of North America were similarly participatory and democratic. When formal organizations for governance are established, the persons holding offices may be chosen at such public meetings, as was true of many kings in

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<sup>7</sup> The word “ting” is still used in the names of two Scandinavian national parliaments. For example, the Norwegian parliament is called the Stortinget (the great ting) and the Danish parliament is called the Folketing (people’s council). The Swedish parliament is called the Riksdag, or royal day after the day at which such assemblies would be held in the early days of the kingdom of Sweden.

northern Europe during the medieval period, and mayors and other town administrators in the North American English colonies.<sup>8</sup>

Being consensus based, the rules adopted by commonwealth governments tend to reflect both the preexisting ethical dispositions and shared pragmatic interests of community members. In such cases, a community's law may be said to have a moral character and to be grounded in ethics, as argued by Aristotle, Locke, Bentham, and Kant among many others. Through time both the informal and formal laws would be subject to evolutionary pressures of the variety that Spencer and Hayek discuss.<sup>9</sup> Emergent governments grounded in tradition and consensus thus tend to enforce rules that have ethical foundations and which promote at least the minimum degree of economic output required for survival.<sup>10</sup>

Such laws would tend to have moral legitimacy from a contractarian perspective insofar as such governments and their associated laws are believed to advance the shared interests of community members. They may also be regarded to be legitimate by utilitarians insofar as they actual-

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<sup>8</sup> Several such cases are discussed in Congleton (2011b). These commonwealths, although reasonably durable, were often conquered by authoritarian regimes, who kept some of the preexisting institutions in place, as with tings. In such cases, national democracies often emerged in the nineteenth century via negotiations with between kings, their councils, and parliaments (or tings). See Congleton 2011a.

<sup>9</sup> Locke and Kant suggest that even in the case in which a community is grounded in a social compact or universal law, many laws would lack a foundation in ethics. They may be adopted simply to solve problems of life in a community, such as rules for walking or driving on the right. Bentham argues that there are also ethical rules that should not be codified in law because the benefits of doing so would be smaller than the costs. In other cases, the laws may conflict with ethical theories.

<sup>10</sup> The multiplicity of ethical theories and institutions around the world suggest that a broad range of rules can advance a community's survival prospects. That same evidence suggests that only a relatively small subset of those formal and informal rules are supportive of democratic governance or commercial societies.

ly do advance the shared interests of community residents. Emergent states may also be deemed legitimate by normative theories of the community itself, because the laws tend to reflect the internalized ethics and other norms of community residents.<sup>11</sup>

Although participatory or democratic regimes have a long history, they, like authoritarian regimes, benefit from a subset of ethical dispositions. Montesquieu (1748), for example, argued that a particular ethical dispositions such as prudence and self-discipline are necessary for democracies to function well.<sup>12</sup> Recent research suggests that some internalized norms may be prerequisites for democratic governance, rather than merely complementary to it. Two fundamental problems are analyzed below to illustrate why ethical dispositions may be especially important for the viability of governments based on majority rule: (i) the indecision/cycling problem and (ii) the redistributive poverty trap.

### A. Ethical Dispositions and Majority Cycles

The early public choice literature demonstrated that majority decision making is not always internally consistent (transitive). This can reduce the stability of democratic regimes and in some cases can undermine majority rule as a method of collective decision making.<sup>13</sup> The cyclic majority problem is not just a theoretical peculiarity, as it is sometimes presented, but rather is a fundamental problem with majority decisionmaking that must be overcome if majority rule is to be a useful method of collective

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<sup>11</sup> For example, Nozick (1974, ch.5) discusses how a centralized enforcement authority might emerge from a society that initially used only informal procedures for self-defense, rather than through the imposition of laws by a dominant military organization. Locke's (1689) political theories were informed by the experiences of the North American English colonists.

<sup>12</sup> Montesquieu argued that political ethics were more important in democracies and aristocracies than in autocracies, but acknowledge that ideas of "honor" tended to play the role of ethics in unrestrained monarchies.

<sup>13</sup> See, for example, Black (1948, 1958). See Mueller (2003) for an overview of this literature.

choice. Evidently, it is often overcome through various shared ethical dispositions.

To illustrate this problem, imagine a village located in a territory where roving bandits exist. The community decides that a defensive wall would solve problems associated with such raiders. Suppose that the wall can be constructed with 1200 hours of labor. Now consider efforts to divide this burden among three equally sized groups in the village—shepherds, masons, and merchants—at a town assembly that will make its decision using majority rule. One proposal might be to simply divide up the costs equally among the three groups. Such an apportionment may be plausibly justified by the common interests advanced by the wall. The distribution of the tax burden or cost shares can be written as  $(T_{\text{shepherd}}, T_{\text{mason}}, T_{\text{merchant}})$  which in this case is (400, 400, 400).

A second proposal for funding the wall's construction might be based on comparative advantage. Perhaps, the wall should be provided by those best able to provide the needed services, which in this case would be those already skilled at wall construction. Some might argue that the middle-class masons should be public spirited and construct the wall for the city, while the other groups contribute toward the materials (200, 800, 200). A third proposal might be developed based on differences in the ability of the townspeople to pay for the wall. Proponents of that view might argue that the community should take account of wealth differences among citizens. The actual labor might be hired from neighboring communities, rather than provided by the villagers themselves. The payments collected pay for hours of labor, rather than directly provide it, but can nonetheless be represented in terms of hours paid for, as with (100, 400, 700).

Proponents of a fourth proposal might argue that the shepherds could benefit from learning the craft of masonry and, moreover, have more free time available for undertaking the required work. The shepherds have the most to gain and the least to lose by undertaking most of the work. Indeed, it could be claimed that the merchants were already carrying the burden of expanding the town's cathedral (600, 500, 100).

All four systems are sufficient to assure that the public good of interest is provided, and all are Pareto efficient. Thus, any will serve.<sup>14</sup> Unfortunately, majority rule fails to settle on one of these tax systems when votes are cast entirely on the basis of self-interest. There is a majoritarian cycle. The first proposal loses to the second, the second by a vote of two to one. The second similarly loses to the third, the third to the fourth, and the fourth to the first. Thus, no defensive wall may actually emerge from majoritarian deliberations. As a consequence, the town will continue to be ravaged by the roving bandits or may be annexed by one of the neighboring authoritarians.<sup>15</sup>

Internalized norms can limit the domain of policy alternatives in a manner that helps assure stability. For example, a consensus that taxes should be based on ability to pay limits tax systems to a relatively small subset of tax systems. Only proposal 3 was consistent with that norm. A cooperative view of the group enterprises might favor equal contributions of the others, which only proposal 1 satisfies, and so forth.

Useful norms for cost sharing are not unique, they merely have to concentrate voter interests on a relatively small subset of cost-sharing (tax) systems in a manner that increases the decisiveness of majority rule.<sup>16</sup> Decisive choices might also emerge if there is a customary method of public finance, and a tendency to defer to tradition as opposed to in-

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<sup>14</sup> A Pareto efficient tax system has the property that any reduction in the financial obligations of one group necessarily reduces the welfare of other taxpayers, holding revenues and planned expenditures constant.

<sup>15</sup>The four step cycle is contrived for purposes of illustration. Such cycles are always associated with every “dividing a pie” decision among pragmatists under majority rule. If each voter wants a larger slice of the pie (or smaller part of the tax burden to pay for a desired service), there is always another division of the pie that can achieve majority support—albeit not simultaneously for all. The four divisions of tax burden used are simply one of the infinity of possible cycles.

<sup>16</sup> Usher (1981) demonstrates that tax systems that preserve the pretax rank order of income tend to be more stable under majority rule than those that do not.

novate. Deference to traditional methods of finance by a sufficient number of voters would also reduce cycling problems associated with cost-sharing decisions. Cycles may also be curtailed by procedural norms. For example, it may be widely regarded as improper, unfair, or unsportsmanlike to reintroduce tax schemes that have already been rejected. In such cases, deliberations among the four proposals would end in the third round, but the order of voting, rather than the merits of the proposals, would be determine the result.

In the illustrating example, a unique outcome emerges if at least one of the two groups has internalized norms that yield a total burden (including guilt or loss of honor) for their own financially best tax system that is greater than that of one of the other three proposals. If only one type of tax system is broadly supported by a community's dominant normative theory, others would be rejected, because they yield burdens that are "improper" or "unfair," or ones that could only be adopted by "improper" or "unfair" procedures.<sup>17</sup>

A variety of internalized norms—although not all—can thus stabilize both the constitutional and day-to-day levels of democratic politics by increasing consensus and reducing the politically feasible domain of policy deliberations.

## B. The Median Voter, Redistribution, and the Poverty Trap

Given a customary or ethically-based tax system sufficient to assure that majority rule generates unique choices for tax and services levels, the next issues involve whether the choices reached are ones that tend to support an attractive society. Not every majoritarian choice does so. This was, for

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<sup>17</sup> In this manner, what might be considered morally expressive voting can eliminate the cycle and yield a definitive majority choice. Brennan and Lomaski (1997) argue that most voters tend to vote expressively, which implies that their ethical theories tend to have greater weight in the voting booth than in ordinary life. Although Brennan and Lomaski are most interested in cases in which problems emerge from such voting behavior, the above analysis implies that that the results can be better than what would have emerged from narrowly self-interested voting.

example, evidently a concern for both Aristotle and Montesquieu, who were concerned about the prudence of some voters. For example, severe economic problems may emerge when voters cast their votes in pragmatic manner with respect to redistributive policies. Rather than producing an attractive society, the result of such voting tends to be an impoverished community.

The redistributive dilemma can be illustrated with a few equations and a diagram. Consider, for example, votes over policies with respect to a demogrant program of redistribution. Suppose that the demogrant is to be financed with a uniform proportional tax on everyone's total income of  $t$  percent. The tax revenues are used to provide equal lump sum payments (demogrants) to each person in society. Voter "i" would have after-demogrant income of  $X_i = (1-t)Y_i + G$ , where  $Y_i$  is voter i's pretax income,  $t$  is the tax rate, and  $G$  is the demogrant. Because  $G$  is paid for through taxes,  $NG = \sum tY_i$ , which after dividing both sides by  $N$  implies that the grant financed is simply  $t$  times average income,  $G = tY^A$ , where  $Y^A$  is average income. If individuals are pragmatic income maximizers, they will favor the tax-grant combination that sets their marginal benefits from the demogrant equal to their marginal tax cost. However, this equality, perhaps surprisingly, may never occur.<sup>18</sup>

Figure 11.1 illustrates a voter's net benefit maximizing choice under two scenarios. In the first, taxes do not affect work effort or income. In that case, the marginal benefit from the tax is always  $tY^A$  and its marginal cost is simply  $Y_i$ . If a voter has below-average income,  $Y_i < Y^A$ , the marginal benefit from the demogrant exceeds the marginal cost of the tax over the entire 0–100% range, and their preferred tax rate is 100%, the upper bound of this tax and transfer program. If a voter has above-average in-

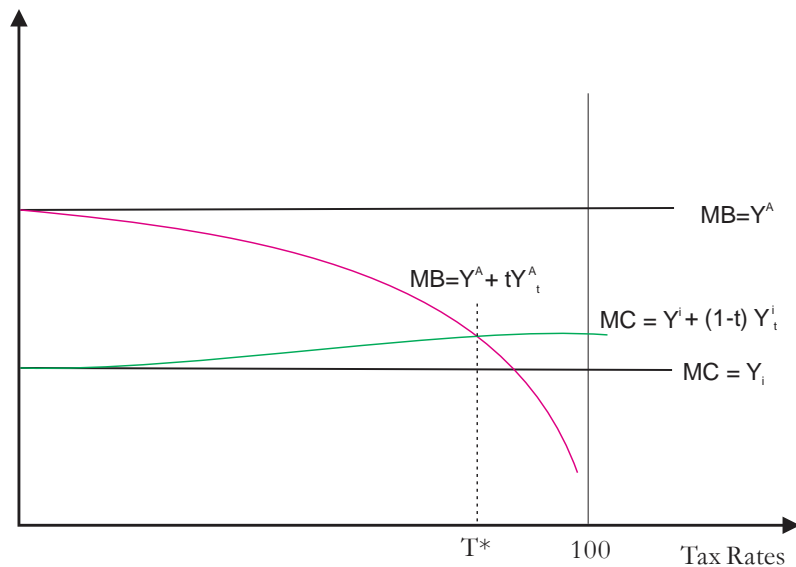
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<sup>18</sup> This demogrant program is a slightly simplified version of that used in Meltzer and Richards (1981). Meltzer and Richards, however, fail to point out the possible corner solutions to a demogrant program when voters cast votes entirely on the basis of their pecuniary interests. (They focus on case 2 below, where the tax base falls as taxes increase.) Majoritarian stability and a median voter outcome emerges from the assumed structure of the transfer program: equal grants financed by a proportional tax, which implies a single control parameter (either the tax rate or demogrant size).



come, the reverse holds, and his or her preferred tax rate is 0%. In the case in which taxes have no or only very small disincentive effect, the distribution of voter preferences is bimodal and the median voter is determined by median income. If the median voter has below-average income, as is usually the case, the tax chosen will be 100% and the demogrant program assures that every voter's income is the same and equal to the average in the community of interest. This is also the utilitarian optimum for this case.<sup>19</sup>

Figure 11.1 The Transfer Poverty Trap



<sup>19</sup>The analysis implicitly assumes that voters are either perfectly informed or that the information problems confronted by voters are indirectly solved through aggregation. The Condorcet Jury Theorem implies that if a sufficient number of voters are diligent policy analysts and gather enough information to cast reasonably intelligent votes (e.g., ones that are likely to advance their pragmatic and moral interests), competitive electoral outcomes provide unbiased estimates of the policies that most advance the interests of the median voter (Congleton 2007a).

In the second case, work, saving, and investment are all affected by the private returns from those activities. In this case the tax and redistribute system tends to reduce effort and average income. This incentive effect tends to change some voters' ideal tax rate, because it reduces the marginal benefits associated with the demogrant program. A given tax rate now produces a smaller demogrant than before, because average income falls as the tax rate increases. The red MB line characterizes the new marginal benefit curve ( $MB_i = Y^A + tY_t^A$  with  $Y_t^A < 0$ ). The green MC line characterizes a typical voter's marginal cost for the program, including his or her own reduction in work effort and income ( $MC_i = -Y_i + (1+t)Y_{ii}$ ). Higher taxes now reduce work effort, income levels, and the tax base available for the demogrant program.

When the incentive effects are taken into account, some voters will prefer intermediate levels of taxation and transfers, as in the case illustrated. The result is normally a smaller preferred demogrant program, a point emphasized in Meltzer and Richards classic paper on majoritarian redistribution (1981). However, the poorer the median voter is relative to average income, the higher taxes tend to be. With very poor median voters, taxes again approach 100%, and personal income levels again decline toward subsistence levels. The result of a demogrant program in such communities is a population of more or less equally poor persons engaging in a good deal of leisure.<sup>20</sup>

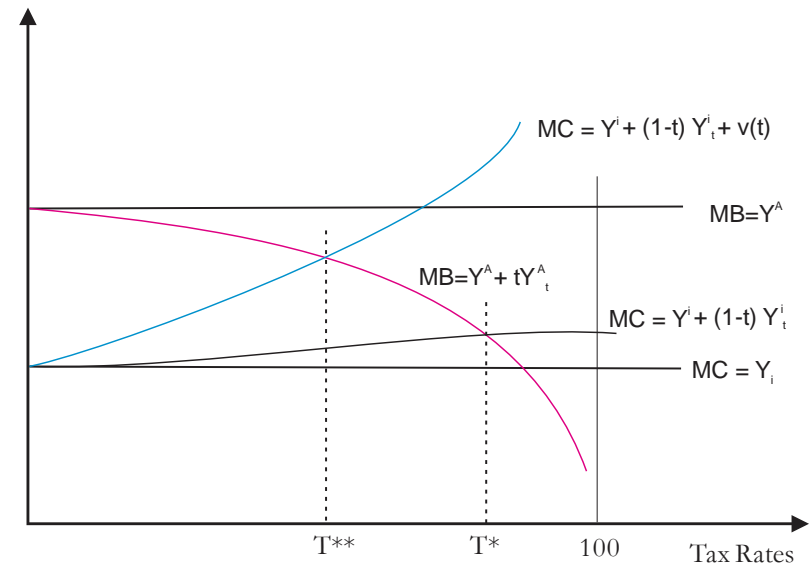
Thus, a community in which the median voter is initially poor relative to average income is likely to become poorer still if a demogrant program is adopted and voters cast votes based on their short term pecuniary interests. This outcome is the democratic poverty trap. Such communities undertake more redistribution than would maximize aggregate utility. (A somewhat more general analysis of such a tax system is undertaken in the appendix.)

<sup>20</sup> Aristotle recounts an instance in Megara, where redistribution led to the end of democracy. The democracy in Megara was also overthrown in a similar way. The popular leaders, in order to be in a position to confiscate their goods, expelled many of the notables, until they had created many exiles, who then returned, defeated the people in battle, and established an oligarchy. [*The Politics*, Second Edition (p. 139). University of Chicago Press.]

A variety of internalized ethical dispositions and other norms can reduce this risk. What appears to be common in democracies with extensive commercial economies are internalized tax and fairness norms that reduce the domain of redistribution. For example, it may be widely believed that market rewards reflect just deserts, that transfers undermine the virtue of recipients, or that private property is sacred and tax and transfer programs are tantamount to theft. As one violates such internalized norms by increasing the magnitude of redistribution, there is a virtue or guilt premium that must be borne. Tax and transfer systems would also tend to be reined in through utilitarian or contractarian norms insofar as they oppose redistribution that reduce wellbeing in the community of interest. If the median voter has internalized such norms, less redistribution will be demanded, taxes will tend to be lower, and economic output higher.

Figure 11.2 illustrates the effects of such internalized norms on the demogrant program. The norms internalized by moderate voters are assumed to increase their subjective burdens for tax and transfer programs by amount  $v(t)$ , which represents the marginal guilt or loss of self-esteem associated with inappropriate types of taxation or transfers (blue line). The new ideal tax rate is characterized by tax rate  $T^{**}$  in the diagram. In such cases, internalized norms inhibit both large demogrant and their associated high taxes. As a consequence, a voter's ideal demogrant program tends to be smaller than ones based on economic interests alone,  $T^{**} < T^* < 100$ . The greater the guilt or loss of self-esteem associated with redistribution is at the margin, the smaller is the ideal demogrant program.

Figure 11.2 Escaping the Transfer Poverty Trap



Indeed, under some norms, tax and transfer programs per se may be ruled out entirely, in which case only social insurance programs might be adopted. Under the prevalent ethical theories of the nineteenth and early twentieth centuries, government income-support programs could only be legitimately targeted at persons experiencing bad luck (unemployment or ill health), rather than below-average income, per se. Such norms indirectly increase the size of the commercial society by reducing the disincentive effects of taxation, rather than directly through policies that reduce transactions costs, increase human capital, or encourage innovation. Contrariwise ethical innovations that reduce such inhibitions tend to reduce the size or growth rate of the commercial society.

Another possible solution is the adoption of formal institutions that limit redistribution. Constitutional constraints, such as takings clauses and restrictions on tax rates or tax base, can reduce the risk of a democratic poverty trap by reducing the extent to which a community's economic wealth is available for transfer or other government programs. Utilitarian and contractarian logic support redistribution, but also support constraints when there are tendencies for excessive redistribution to take

place.<sup>21</sup> Redistribution, per se, is not a good in and of itself from either the utilitarian or contractarian perspectives. It is good policy only when it increases aggregate utility or generates universal support for the anticipated post-agreement society. The extent to which a democratic government should have the authority to adopt demogrant programs or other similar programs depends on the expected results.

#### IV. Pragmatic and Ethical Interest Group Politics

The right to assemble and petition government is assured by all liberal democracies and is also possible for most groups in all but the most authoritarian of dictatorships. This right allows groups to form and lobby in favor of or against all manner of political, social, and economic purposes. Such political rights characterize legal methods through which groups can attempt to affect public policy through persuasive campaigns inside and outside of government in a manner disproportional to their numbers.

The policies favored by pragmatic groups are often—although not always—narrow ones that confer net benefits on a group’s members and net costs on persons outside the group in the form of higher prices, increased transactions costs, higher taxes, or unfavorable regulations. Commercial groups, for example, often lobby for entry barriers of various kinds that shield their members from competition. Public policies that do so include explicit grants of monopoly privilege, protective tariffs, regulations with grandfather clauses (which impose higher costs on new entrants), licensing, and narrowly targeted subsidies. Suppliers of government services also often lobby for better contract terms than possible in more competitive markets.

In all of these cases, the lobbying activities consume time, talent, and attention. The costs of such rent-seeking activities include both the less

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<sup>21</sup> Brennan and Buchanan (1980) analyse a variety of such constitutional constraints on taxation.

than ideal policies adopted and over investments in political activities and the opportunity cost of all the resources used in the lobbying process.<sup>22</sup>

#### A. Rent Seeking

Table 11.1 illustrates the escalating tendency of lobbying contests and the effects that competition among interest groups have on the profits from engaging in such contests. The Nash equilibrium implies relatively high lobbying efforts and relatively low profits from such contests. In evenly matched contests of the sort illustrated, each organization would benefit if all could credibly agree to limit the extent to which their resources are invested in this process. However, no other outcome is stable. The rivals all benefit from violating such informal agreements, both if they expect others to adhere to them and if they do not.

**Table 11.1: The Rent-Seeking Contest**

	<i>Arye</i>		
	<b>1 Lobbyist</b>	<b>10 Lobbyists</b>	<b>50 Lobbyists</b>
<i>Gordon</i>	<b>(G, A)</b>	<b>(G, A)</b>	<b>(G, A)</b>
<b>1 lobbyist</b>	<b>(6, 6)</b>	<b>(4,8)</b>	<b>(1, 10)</b>
<b>10 lobbyists</b>	<b>(8, 4)</b>	<b>(5,5)</b>	<b>(2, 6)</b>
<b>50 lobbyists</b>	<b>(10,1)</b>	<b>(6,2)</b>	<b>(3, 3)</b>

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<sup>22</sup> Political-economy models of losses associated the activities of pragmatic groups (economic interest groups) emerged in the decades after World War II. Mancur Olson (1965) developed analytical models that explained why relatively few interest groups attempt to advance general interests. Gordon Tullock (1967, 1980) more fully accounted for the losses associated with such efforts. The losses associated with the process of lobbying and similar activities came to be called rent seeking, a term coined by Anne Krueger (1974). (To an economist, a “rent” is unearned income, rather than an amount paid to use a room or house.) Tullock (1967) argued that resources are consumed by the process of seeking privileges and other policies that reduce social net benefits are part of the deadweight loss of socially unproductive policies.

When economic interest groups succeed in their efforts to obtain privileges, those outside the contest are often made worse off through higher prices, higher taxes, or less variety, all of which tend to reduce the size and scope of commerce. A total accounting of the losses from lobbying by narrow interest groups includes reductions in social net benefits generated by exchange and the cost of the non-productive efforts to obtain protection from competition.

The “crony capitalism” that emerges from successful rent-seeking tends to both reduce the extent of the commercial society and increase inequality.<sup>23</sup> Such results would be opposed by both utilitarian and contractarian analysts.

## **B. Illegal Forms of Rent Seeking: Ethics and Corruption**

Although, there are often gains to trade between buyers and sellers of political influence, there are external costs beyond those transactions. Those costs usually exceed the benefits realized by those buying and selling government favors. For example, taxes may rise for most other persons in a community if more is paid to government contractors than required to elicit their services. The prices of goods and services rise for consumers of services sold in less competitive markets than would have existed without protective tariffs and other laws that reduce competition. It is to avoid such losses and also to conform to community norms of fair and just procedures that laws against some forms of lobbying and influence (such as bribery) are nearly universal.

Unfortunately, anti-bribery and similar laws are difficult to enforce. This is partly because the enforcers of such laws are often among the potential beneficiaries of corruption. Those who enforce anti-corruption laws normally have discretion over how the laws will be implemented. Discretion is exercised over the extent to which a possible instances of corruption are investigated, whether to bring particular persons or organ-

izations to trial, the strategies used in court proceedings, and the stringency of punishments imposed on persons found to be guilty.

As in other areas of law, this discretion can be used to increase the effectiveness of law enforcement and to reduce the losses associated with violations of and exceptions to existing laws. Alternatively, it can be used to shield friends, families, and the powerful from the laws others must follow. Pragmatists seeking privileges will naturally attempt to influence the decisions of government officials with relevant discretion.

In general, the further up the chain of responsibility for creating and enforcing the law one goes, the more difficult it is to detect and punish favoritism and corruption. This is in part because the methods of bribery and extortion employed at higher levels are often more roundabout and less easily observed by persons outside an agency. It may simply involve the trading of favors, the opening or closing of doors of opportunity, job offers, valuable information about investment opportunities, and the like. The more subtle are the means, the more difficult it is to detect corruption and the more difficult it is to write laws that discourage it.

The effectiveness of anti-corruption laws, like most others, depends partly on the formal reward and recruiting systems of the law enforcing agencies, and partly on the normative dispositions of those attracted to government service. An anti-corruption agency that is staffed by lazy and untrustworthy persons and given few resources, is unlikely to enforce anti-corruption laws very well. An anti-corruption agency staffed by hard-working pragmatists might tend to amass personal fortunes from those violating the laws (and those who can be made to appear so), rather than enforce the law. Indeed, without internalized norms against taking bribes, legislation and regulations might well be adopted with opportunities for rent extraction, graft, and favoritism in mind.<sup>24</sup>

Internalized norms provide politicians and bureaucrats with ethical reasons to pass anticorruption laws and to refrain from accepting bribes or engaging in favoritism. In the broader society, such norms can reduce the extent to which bribes are offered or rent-seeking lobbying undertaken. Firm owners, for example, might prefer to earn their money “honest-

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<sup>23</sup>For non-escalating models of equilibrium rent-seeking efforts see Tullock (1980) or Hillman and Kats (1984). For an accessible overview of the rent-seeking literature, see Congleton and Hillman (2015).

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<sup>24</sup>See McChesney (1987) for illustrations of such rent-extracting policies in the United States, a relatively well-run and honest government.

ly,” rather than as a consequence of a regulatory privileges or subsidies. Widely held norms against favoritism may also produce political pressures for reforms that discourage such possibilities.

### C. Ethical Interest Groups

It also bears noting that not all interest group activity is intended to increase profits. Ethical dispositions often encourage lobbying efforts by groups with aims grounded in moral philosophy. Participating in such campaigns is often considered praiseworthy or virtuous behavior. Ethical interest groups have a long history and often are able to succeed in their reform agendas. For example, a long series of economic and political reforms in the nineteenth and twentieth centuries were advocated by utilitarians and other groups with similar normative goals. Their persuasive enterprises helped induce the reforms that created the legal framework for contemporary commercial societies and democratic governance in nineteenth century Europe, (Congleton, 2011).

Public interest lobbying often counter the efforts of profit-maximizing rent seekers by undermining their arguments and pointing out the narrow interests being advanced. An indication of the success of campaigns against corruption and rent seeking is that it is often difficult to determine whether a particular group is a rent-seeking or an ethical interest group. To reduce opposition from idealistic groups, pragmatic groups often find it useful (more persuasive) to argue that their preferred policies are public spirited and advance general interests, rather than being simply one of their many strategies for maximizing profits or power. It is a very rare group that will publicly argue that a particular policy should be adopted simply because it increases their member’s profits.

Moral narratives are thus nearly always part of the public campaigns of interest groups. Such rhetoric would not be used, of course, unless it was widely believed that moral arguments were persuasive. This is most likely when the relevant ethical dispositions are already commonplace within the electorates of interest. Indeed, coalitions of ethical and pragmatic groups often lobby for the same policies. That ethical interest

groups are important at the margin tends to reinforce or extend the ethical foundations of public policy and constitutional governance.<sup>25</sup>

Although ethical systems tend to agree on many public and private issues, they do not agree on all points. For example, not all ethical groups have goals or only use methods that are consistent with the aims of welfare economics, utilitarian ethics, or contractarian theories of legitimacy. The policy aims of many ethically grounded interest groups tend to undermine, rather than support democratic governance and/or the commercial society. Moreover, contests between ethically motivated groups can also consume enormous resources and without benefiting others outside the contest.

Whether net benefits or losses are produced by the activities of ethically motivated groups, as true of other groups as well, depends on the magnitude of the net benefits produced for others and the resources consumed by the rival groups.<sup>26</sup>

### V. Ethics, Politics, and the Ideal Scope of Governmental Authority

Just as the regimen of the healthy is not suited to the sick, one must not try to govern a corrupt people by the same laws as those that suit a good people. Nothing proves these maxims better than the long life of the Republic of Venice, which still retains a simulacrum of existence, sole-

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<sup>25</sup> To the extent that trust increase with the extent to which policies advance moral rather than pragmatic ends, such “reformed” governments are likely to be more trusted than one that lack “proper” incentives or are staffed by persons without widely accepted values.

<sup>26</sup> For a mathematical examination of the efforts of ideological and pragmatic interest groups, see Congleton (1991). It bears noting that many international and civil wars have been fought between rival ethical groups, as with the many religious wars of Europe, the Levant, and North Africa. It is doubtful that any of these produced aggregate net benefits for those involved.

ly because its laws are suited only to wicked men. [Rousseau (1997/1755) *The Social Contract*. p. 135]

All the above implies that governments are not always, nor automatically, benevolent instruments for increasing social welfare or aggregate utility. Whether they do so or not depends in part on their constitutional designs and in part on the skills and normative dispositions of the persons holding high office. The standing routines of governance, the policies chosen, and how they are implemented all are influenced by—although not entirely determined by—the ethical dispositions of policy makers, bureaucrats, and, within democracies, the electorate.

The anticipated ethics and competence of government office holders thus affect the ideal delegation of authority to government from utilitarian and contractarian perspectives and from other consequentialist normative theories. Governments staffed by ethical and competent individuals will yield good results, essentially by definition. The nature of “good results,” however, varies according to the aims of government and associated ideas of the good society and the good life associated with those aims.

For a liberal democracy, the aim is to advance general or at last majoritarian interests. This makes the ideal delegation of authority similar to that of a homeowner hiring a contractor or a firm a new employee. The more trustworthy and competent a contractor or firm, the more authority can be safely delegated to those persons. The less trustworthy and competent, the more monitoring will be necessary, the more detailed the contracts, and the more restricted the matters left to the contractor’s or employee’s judgement. In the case of democratic governments, the more trustworthy and competent government decision makers are at advancing general interests, the more discretion would be accorded them. The less competent and trustworthy they are or appear to be, the more limited would be that discretion. Terms of office would be short, frequent elections would be held, and clear constitutional guidelines for government action would be crafted and agreed to by the citizen-voters. Ethical and practical considerations both play roles in these assessments.

### A. On the Use of Personal Ethics for Assessing Officials, Policies, and Institutions

Most ethical codes of conduct allow one to assess both the virtues of one’s own behavior and that of others. In this respect, all personal ethical systems are generalizable. Theories of character and virtue can thus be used to assess policy makers and their policy choices. There is nothing new about this, although the freedom to write down one’s opinions about government officials without fear of retribution is a relatively recent phenomena, and far from universal.

For example, La Court (1662) regarded the nobility of the Netherlands to be less than praiseworthy. They could not generally be trusted to pay their debts, deal courteously with women, or exercise self-discipline with respect to drinking or public policy.

**Inferior lords** usually and **without scruple** take possession of their paternal estates without paying any debts; and all young and healthy lords are violently inclined to women...indeed two of these having either never married at all, or not until they were of a considerable age, and could not have been **guilty of so many crimes** if they had been engaged in marriage.

As to the **profusion and excess of drinking** used in their court, to the great diminution of its revenues, ’tis a thing so universally practiced, especially in the Northern parts, that none of these princes ought to be so much blamed for it.

[In contrast] prince Maurice **deserves to be commended for the frugality and sobriety of his family**. [Pieter de la Court (1662). *The True Interest and Political Maxims of the Republic of Holland*. (p. 10)].

La Court was simply applying the Calvinist norms held by many persons in the Netherlands in this critique of noble character and behavior. Government officials should behave just like the rest of us, with prudence and frugality.<sup>27</sup>

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<sup>27</sup> It is interesting to note that the terms “noble“ and “ignoble“ were often used to describe both family lineage and personal character. Whether

Public policies can often be assessed in more or less the same manner. Both day-to-day and quasi-constitutional policy choices may be considered unethical because they violate norms associated with life in a community or with virtuous conduct in general. Again, quotes from La Court serve as an illustration.

[T]he **governors** of the United Provinces, who seemed **willing to give up the liberty of their country**; and in all respects to be able, willing and necessitated to bear an universal slavery, **by granting and promising to a child the future succession of all his father's offices**; and whether the said prince *William* the second, **who was continually conversant with foreigners**, and other slavish courtiers, had any better education or conversation with men than other ordinary monarchs use to have.

**To grant authority to a child without knowing how he will grow up is the height of imprudence**, risking both incompetent leadership and worse. [(1662) *The True Interest and Political Maxims of the Republic of Holland*. (p. 13).]

In this case, Dutch policy makers are being criticized for taking risks that a thoughtful, prudent, man would not—that is for letting emotion and tradition, rather than reason determine their choices.

By the mid-nineteenth century, Bastiat was able to use other commerce-supporting norms in his critique of tax policies in France.

But when John Q. Citizen **gives a hundred sous to a Government officer, and receives nothing** for them unless it be annoyances, **he might as well give them to a thief**.

It is nonsense to say that the Government officer will spend these hundred sous to the great profit of national labor; the thief would do the same; and **so would John Q. Citizen, if he had not been stopped on the road by**

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Dutch nobles were unusually ignoble in their behavior or not is beyond the scope of this chapter.

**the extra-legal parasite, nor by the lawful sponger.**

[Bastiat (1850) “That Which Is Not Seen,” *The Bastiat Collection* (p. 9).]

The rhetoric of political and lobbying campaigns continues to draw heavily on the internalized personal ethics of voters to critique and support alternative candidates and public policies. Candidates may be deemed trustworthy or not, reckless or not, thoughtful or not, and so forth. The importance of character and trustworthiness is evidenced by their role in the advertising campaigns and speeches of rivals for high office, which tend to stress character over policy in most cases. Policies involving war and peace or environmental quality also tend to be assessed substantially by their moral appeal. From the perspective of personal ethics, government officials and agencies should do the right thing, which may combine aspects of beliefs about universal duties with ideas about justice and prudent decision making.

Conclusions about political office holders may in turn be used to assess political institutions. Institutions that tend to select and retain amoral or corrupt officials, may be regarded to be amoral or corrupt as well. As particular definitions of duties and good consequences vary, so would conclusions about the ideal assignment of responsibilities to governments and their employees. In this manner, personal ethics can serve as a foundation for assessing the merits of an entire systems of government.

More systematic and encompassing normative theories, as with utilitarian and contractarian theories, can also be used to assess candidates and their policies. Although such theories are not prerequisites for assessing political or economic systems, they do tend to induce more systematic, detailed, and rigorous ethical, political, and economic reasoning.

Of interest for the purposes of this book is the tradeoff between regulatory authority and the extent of commerce. The extent of commerce is generally utility enhancing and thus tends to be supported by utilitarians and contractarians, other things being equal. However, regulations and public expenditures may reduce external costs or increase net benefits if they are appropriately undertaken. Whether the delegation of authority to government to undertake such policies and programs improves society or not depends in large part on one's assessment of the relative performance of markets and democratic governments in the particular markets and policy areas of interest.

## B. Welfare Economics and the Delegation of Authority to Democratic Regimes

In general terms, **the practical question, where to place the limit—how to make the fitting adjustment between individual independence and social control**—is a subject on which nearly everything remains to be done. All that makes existence valuable to any one, depends on the enforcement of restraints upon the actions of other people. Some rules of conduct, therefore, must be imposed, by law in the first place, and by opinion on many things which are not fit subjects for the operation of law. **What these rules should be, is the principal question in human affairs.** [Mill, John Stuart (1859/2013). *On Liberty* from the *Complete Works of John Stuart Mill* (Kindle Locations 39783–39787).]

The remainder of the chapter focuses on what Mill argued was the principle question in human affairs, the extent to which authority should be delegated to a community's government. For both utilitarians and contractarians, the proper domain of democratic authority varies with the expected outcome. In areas in which outcomes are likely to be improved via majority rule, both utilitarians and contractarians will prefer democratic interventions, although the meaning of "improved" varies somewhat among utilitarians and contractarians. In other cases, authority to intervene should be withheld.

Even Mill's own analysis of this question suggests that there is not a unique ideal degree of delegation from either utilitarian or contractarian perspectives, although the factors to be considered are often clear. Bentham and Spencer supported laissez-faire, as did Mill in most cases. Mill, however, acknowledged the possibility of externality problems. From Pigou onwards, utilitarians supported increasingly broad government authority to intervene in markets, partly because externalities were taken to be more prevalent and important and also because interest in redistribution increased among utilitarians. Much of that analysis, however, assumes that governments are staffed by well-meaning, all-knowing utilitarian rulers.

To properly assess the ideal level of regulatory authority to be delegated to a more realistic government requires taking account of the kinds of policies that democratic governments are likely to adopt. These, in turn, vary with expectations about the ethical dispositions of policy makers and enforcers.

For example, a perfect utilitarian government with no administrative costs—the model of government often used in public economics—should be given the authority to solve any problem for which the expected aggregate benefits are greater than the expected regulatory burden of the solution. However, if administrative overhead adds an additional 10 percent to the regulatory and tax burden, then only problems for which the net benefits associated with regulation are greater than 110% of the tax and regulatory burden should be delegated to government. If agency problems and rent-seeking losses add another 10% loss to the burden of policy, then the ideal delegation of authority should be limited to those with benefits greater than 120% of such costs, and so on. The greater the expected costs of government action—whether simple overhead, errors, corruption, or voter biases (as with fiscal illusion)—the smaller is the ideal scope of government from a utilitarian perspective. As pointed out by Bentham (xxxx) some two centuries ago, laws should not be adopted if they are ineffective, unneeded, or have costs greater than their benefits, which implies that the delegation of authority to adopt new laws and regulations should be limited to policy areas in which their benefits are likely to be greater than their costs.

From a contractarian point of view, the issues are similar, although the analysis differs. Given a democratic government and a legal system that supports a commercial society, the line between the authority of government and the private sector should be chosen to obtain unanimous consent from the individuals in the community of interest. There will naturally be a good deal of uncertainty about both the policies that will be subsequently adopted and the economic developments that will occur after the political institutions are in place. If voters are risk neutral, the government will be delegated responsibilities for goods, services, and regulations in those areas in which social net benefits are expected to increase. If voters are risk averse, authority will be delegated only in the policy areas in which the risk-adjusted average result is expected to be beneficial for essentially all persons.



Government's effectiveness is partly a matter of the ethos of government officialdom and partly of the magnitude of the problems faced. With respect to commerce, the greater the anticipated externality, monopoly, and public goods problems tend to be, the more beneficial delegating regulatory authority to government officials tends to be. The smaller those problems are anticipated to be, the less beneficial such authority tends to be. For a given problem or policy area, the more effective governmental systems are anticipated to be as instruments for improving life and society, the broader will be the delegation of authority to them. The less effective or more problematic government policymakers and policies are anticipated to be, the narrower will be the ideal scope of governmental authority.

In the long run, conclusions about the dividing line are conditional and subject to revision, and so constitutional and quasi-constitutional provisions may be amended from time to time. When constitutional designs improve or constitutional norms evolve in a manner that tends to reduce the risk of governmental malfeasance or increase its effectiveness, the ideal domain of authority tends to increase and vice versa.<sup>28</sup> Similarly, the more ethical and effective market participants tend to be—both firms and consumers—the fewer problems are anticipated and the smaller the optimal degree of delegated authority tends to be, other things being equal.

### C. An Illustration: Utilitarian Choices among Political-Economy Systems

Some light can be shed on general guidelines for the delegation of authority to governments by focusing on a few broad categories of possible government failures, market failures, and scopes for government authority. Table 11.2 illustrates some possible utilitarian conclusions about the proper domain of political authority under different assumptions about the relative performance of democratic politics and markets. Three rough categories of market and governmental performance are used and three political-economy systems are considered: laissez-faire (relatively few in-

<sup>28</sup> Evidence that voters take account of these tradeoffs is provided in the political science and political economy of trust literatures. See, for example, Miller (1974) and Blanco (2013).

terventions in markets beyond enforcement of civil law), mixed (many interventions, but mostly for large market failures and social insurance), social democracy (unrestricted regulatory and tax interventions and redistribution).

**Table 11.2: Market-Politics Tradeoffs**

		Character of Democratic Policy Decisions		
		Excellent	Mediocre	Poor
Character of Market Outcomes	Excellent	Laissez-Faire	Laissez-Faire	Laissez-Faire
	Mediocre	Mixed	Laissez-Faire	Laissez-Faire
	Poor	Social Democracy	Mixed	Laissez-Faire

The conclusions are illustrative, rather than closely reasoned.<sup>29</sup> They are in the spirit of the arguments of Von Mises and Rawls, who suggest that good governance is more dependent on ethical dispositions than effective markets. Thus, when ethical men and woman are equally influential in both systems, relatively fewer government interventions are called for. There would be, for example, fewer externalities, lower crime rates, and better-quality products, and so less reason to intervene. In cases in which governments generally improve on market outcomes, possibly because the average government official is more ethical than the average market participant, or possibly because of the existence of many externality problems beyond the solution of civil law, a clear utilitarian case for more extensive government interventions exists.

More generally, in cases in which market outcomes are always poor (large externalities, a good deal of fraud and monopoly power) and government policies always excellent, very broad authority should be delegated to government. In cases, in which market outcomes are poor, but

<sup>29</sup> At the level of system choices, there is an irreducible element of uncertainty because the necessary information and science required for a complete and detailed description is beyond the ability of any analyst, whether political philosopher or social engineer. Instead, only some general rules or constitutional principles may be possible, which is a possible defence of the course categories analysed in this subsection.

government policies are imperfect, less authority should be delegated. In cases in which public policies are generally poor, either because of random errors, ignorance, systematic bias, or rent seeking, a watchman state is likely to do the least damage.

Analysis from a contractarian perspective tends to reach similar conclusions. If citizens generally expect government policies to increase their own net benefits, which in most cases will be correlated with social net benefits, they will be disposed to delegate more authority to their community government. If significant agency problems exist or voter ignorance is anticipated to be extensive, governments would be granted authority only in policy areas in which gains appear to be largest and most likely. In cases in areas in which few or no personal net benefits are anticipated, authority would be withheld. Redistribution might, for example, be limited to various community insurance programs that are likely to advance the interests of all subscribers.

Other ethical systems might reach somewhat different conclusions about the optimal delegation of authority to intervene in markets or lifestyles. Many egalitarians, for example, would support far greater community control and far less personal autonomy in order to force equality in opportunities and outcomes, as in More's utopia. Not all ethical systems are supportive of discretion in private lives or public policy, nor supportive of the policies that help a commercial society to emerge.

## **VI. Conclusion: Ethics, Governance, and Public Policy**

This chapter has argued that governments and their policies are at least partly grounded on ethics and similar normative theories. This applies to government as they are and to governments as they should be. And insofar as conclusions about the latter affect the course of constitutional reform, the analysis also sheds light on political-economic systems as they have been and will be in the future.

Within democracies, public policies reflect both the aims of moderate voters and the choices of elected representatives and unelected bureaucrats, each of which has some discretion over how rules will be created, interpreted, and enforced. As true of any organization, governments are more effective when their systems of reward and recruitment align the

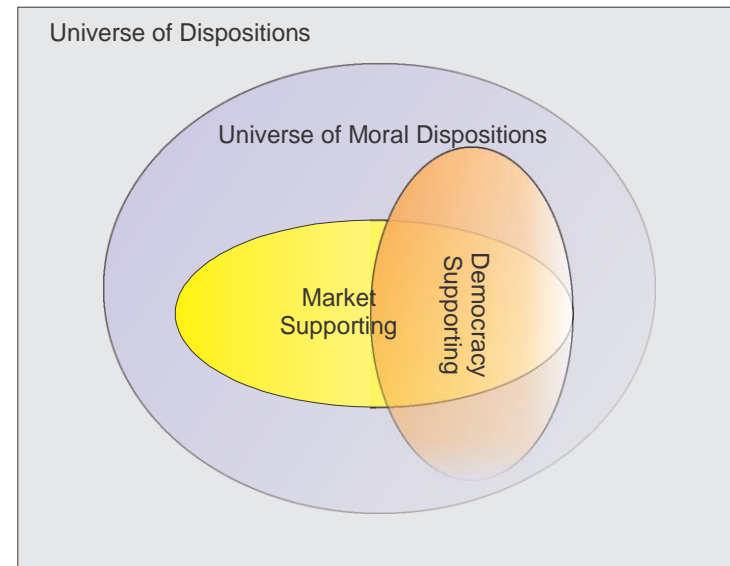
interests of their team members (legislators, magistrates, and employees) with that of the organization. Electoral competition does much of this aligning in well-functioning democracies. However, competition is far from perfect and much that government officials decide occurs and remains largely behind closed doors, beyond the knowledge of voter and media monitoring and assessment.

Such unobserved decisions, apart from some risk of scandal, are private ones. These reflect personal interests, which include both pragmatic and ethical assessments. It is for such reasons that so much time and attention is focused on “candidate character” during elections. Are they honest? Do they have the right values? Can they be trusted to make the right decisions? These considerations, in addition to competence and policy positions, clearly affect voter assessments of the relative merits of candidates running for office, and thereby also affect the public policies that actually emerge from governments as discussions, judgements, and policies of those in positions of authority within government.

Insofar as government policies and their implementation affect economic development, and all of economics implies that they do, the economic systems that we have reflects the ethos of the communities from which politicians, bureaucrats, and voters grow to adulthood in and live in during their adult lives. This is not to say that every community is a moral community in which ethical dispositions are universally internalized by all. But it is to say that the ethical dispositions held by members of a community influence the nature of government officials as they rise to positions of authority and conclusions about how they should be.

Democratic templates are flexible in that they can advance a broad range of ideas about the good society, although not always simultaneously. Any lack of consensus assures that even a relatively well-functioning democracy is likely to be regarded as “failing” in some areas of policy by some people. In a subset of such cases, the failures may be critical, as with the cycling and poverty trap problems analyzed at the beginning of this chapter and with corruption analyzed in the middle. Fortunately, not all failures are critical, although they may still undermine support for a particular government or institutional design.

Long term shifts in ethical beliefs or the strength of ethical dispositions tend to produce long term shifts in the effectiveness of all organizations including governmental ones. Both liberal democracy and the emergence of commercial societies arguably were consequences of such changes. Liberalism, itself, is grounded in particular ethical theories. What political scientists refer to as shifts in “ideologies” are usually shifts in internalized ethical dispositions about the nature of society as it is and the good society that might replace it.<sup>30</sup> Whether the changes in the West during the nineteenth and twentieth centuries should be regarded as “progress” or not is taken up in the next chapter.



- Market supporting ethical dispositions
- Democracy supporting ethical dispositions
- Universe of ethical dispositions
- Universe of all dispositions including ethical and pragmatic ones

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<sup>30</sup> For example, in the eighteenth and nineteenth centuries, there were normative shifts in Europe and Japan that tended to support both open commerce and democratic politics. The civil ethics of what nineteenth century politicians and political theorists termed liberalism became mainstream and commonplace. The ethical component of liberalism included the usual personal virtues of honesty, prudence, diligence, the pursuit of excellence. Its civil ethics supported lawful behavior, tolerance, and equality of opportunity (rights), the latter being what Spencer and Rawls term the equal liberties principle.<sup>30</sup> See Congleton (2011) for a detailed analysis of how liberalism affected political institutions during the nineteenth and early twentieth centuries. Less attractive societies emerge from otherwise similar legal and constitutional systems where and when supporting norms are less common or weaker.

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## Mathematical Appendix: A Simple Model of Redistribution with and without Ethical Constraints

Consider the following model of redistribution based on the Melzer and Richard assumptions. Suppose that people have identical tastes but vary by income and that a proportional tax is to be imposed and used to fund a “demogrant,” an equal grant to all persons in society.

Assume initially that utility is determined by leisure ( $L$ ) and material gratification ( $C$ ),  $U = u(T-L, C)$ , and that people simply consume what they earn after taxes and receive from the demogrant program. This can be thought of as a lifetime pattern of consumption for simple egoists with  $T$  hours to allocate between leisure and gainful employment in the commercial society. Consumption is  $C_i = (1-t)w_iL_i + G$  with  $G = tY^A$ .

Substituting allows utility to be written as  $U = u(T-L_i, (1-t)w_iL_i + G)$ . For a given tax and demogrant, each voter will choose to work his or her utility maximizing number of hours, which satisfies:

$$-U_L + U_C (1-t)w_i = 0$$

The solution to which can be written as  $L^* = l(w, t, G, T)$  with partial derivatives:

$$L^*_w = [-U_{LC} ((1-t)L_i) + U_C (1-t) + U_{CC} (1-t)^2 w_i L_i] / -U_{LL}$$

$$L^*_t = [U_{LC} w_i L - U_C w_i - U_{CC} (1-t) w_i^2 L_i] / -U_{LL}$$

$$L^*_G = [-U_{LC} + U_{CC} (1-t) w_i] / -U_{LL} < 0$$

$$L^*_T = [U_{LL} + U_{LC} (1-t) w_i] / -U_{LL} > 0$$

The last two partial derivatives can be signed using the conventional assumptions about utility functions ( $U_L > 0$ ,  $U_C > 0$ ,  $U_{CL} > 0$ ,  $U_{LL} < 0$ , and  $U_{CC} < 0$ ). The first two are ambiguous, with these assumptions alone and depend upon the relative sizes of the first derivative and second derivative effects.

Demogrants tend to reduce work effort and time available tends to increase it, but whether after tax wage rates increase or decrease labor varies with the relative size of the first and second derivatives. If the second derivatives are assumed to be small relative to the first derivatives, the intuitive results are obtained. In that case, labor increases with wage

rates ( $L^*_w > 0$ ) and decreases with income taxes ( $L^*_t < 0$ ). One special case in which this holds is that in which the utility function is separable with constant marginal utility. In that case, however, the derivatives of labor supply with respect to size of the demogrant and time to be allocated are both zero, which was the case explored in figure 1.

In either case, a voter’s optimization problem with respect to taxes and demogrants can be written as maximize:

$$U = u(T-L^*, (1-t)w_iL^* + tY^{A*}).$$

The median voter’s receives the median wage rate,  $w^v$ . Her preferred tax rate satisfies:

$$-U_L(L_t + L_G Y^A_t) + U_C [(1-t)w_i (L_t + L_G Y^A_t) + Y^A + t(Y^A_t + Y^A_G)] = 0,$$

where subscripts denote partial derivatives.

If we take the case in which second derivatives are zero, the derivatives with respect to  $G$  disappear and we are left with:

$$-U_L(L_t) + U_C [(1-t)w_i (L_t) + Y^A + t(Y^A_t)] = 0$$

These terms can be separated into marginal benefits and marginal costs, with

$$MB = -U_L(L_t) + U_C Y^A$$

and

$$MC = U_C [(1-t)w_i (L_t) + t(Y^A_t)]$$

The marginal benefits come from increased leisure and income from the demogrant, whereas the marginal costs come from reductions in income from working and through economy-wide effects on the tax base associated with similar declines in work effort by everyone in the community of interest.

As noted in the geometric illustrations, there is no assurance that an interior solution exists. The ideal tax could easily be one hundred percent if the labor responses to taxation are small. It could be zero if median income is greater than average income.

In a broad range of cases, taxes may be relatively high and economic activity lower than optimal from a utilitarian perspective. In such cases, internalized tax norms or distributive norms can produce better results than self-interest alone. For example, citizens may have internalized

norms that approve of wage based income differences or disapprove of transfer payments except for those involving extreme need and bad luck.

The influence of such norms can be incorporated into sufficient number of voters utility function that they are also part of the median voter's calculation. (Not all voters need have such internalized norms for them to affect electoral outcomes.)

$$U = u(T-L^*, (1-t)w_iL^* + tY^{A*}, [t^N-t]).$$

The tax norm may be the result of a utilitarian calculation, a fairness consideration, or other norms. The median voter is not necessarily the voter with the median ethical disposition towards taxes, but remains the voter with the median ideal tax rate.

In this case the optimal level of taxation satisfies:

$$-U_L(L_t + L_G Y^A) + U_C [(1-t)w_i (L_t + L_G Y^A) + Y^A + t(Y_t^A + Y_G^A - Y_N)] = 0$$

These terms can again be separated into marginal benefits and marginal costs, with

$$MB = -U_L(L_t) + U_C Y^A$$

and

$$MC = U_C [(1-t)w_i (L_t) + t(Y_t^A)] - Y_N$$

In this case, the tax norm raises the marginal cost of taxation which tends to reduce taxation and under the assumptions adopted above increase average income.

A completely idealistic voter would simply favor their personal tax ideal,  $T^N$ , without regard to self-interest. A pragmatic voter would not have personal tax norms, and would simply vote for the norm that maximized his or her utility, which in this case is approximately the tax system that maximizes their personal net of tax and transfer income. Poverty traps are, of course, very likely in this last case insofar as median income is below average income, a point neglected in the original Meltzer and Richard (1981) analysis of the equilibrium size of a transfer state.