

#### I. Introduction to Part III: Ethics and the Laws of a Commercial Society

Part I and Part II of this book have demonstrated that a subset of personal ethics affects the scope and scale of commerce. Personal ethics do this by encouraging or discouraging persons from participating in commercial activities and through effects on how they behave when they do so. If commerce is immoral, then only the least virtuous will participate, and markets will tend to work poorly. Civil ethics do so by making life in communities more attractive and in some cases by making organizations work more effectively. Honesty and respect for property allows trade to take place at lower risks. Trading networks tend to be broader and commerce a relatively large portion of individual lives.

Without such internalized norms, the process of creating and enforcing rules becomes an entirely external one. External enforcement is inherently less effective than internal enforcement, thus trade tends to be relatively riskier and trading networks tend to be smaller. The goods brought to market tend to be produced by smaller organizations, because firm owners will be more inclined to directly manage their accounts and cash transactions, and to directly monitor their relatively small teams. Insofar as governments are also staffed by amoral pragmatists, the laws are unlikely to be well enforced, but rather used as a tool for extraction. Trading networks and economic organizations in such settings would tend to be much smaller, other than those favored by the rulers.

Part II used equilibrium models from game theory and economics public choice to show how internalized codes of conduct affect a variety of market equilibria in final goods and input markets. Part III explores the extent to which internalized norms, ethical theories, and moral reasoning affect market-relevant public policies, institutions, and economic development. Chapters 9 and 10 survey of twentieth century contributions to the utilitarian and contractarian theories of civil ethics and their relevance for policy analysis. Chapter 11 suggests that many of the same ethical theories that promote markets also tend to make political institutions work better and also to anchor fundamental civil and political institutions.

Chapter 12 explores how ethical ideas affect economic development. Ethical progress is a phenomena that is largely ethical in nature. Moreover, Contemporary research shows that social capital as well as “good” institutions and public policies are highly correlated with economic development. The properties of a nation’s institutions and policies clearly reflect the ethics and other norms of policies makers in the countries of interest.

#### A. Ethical Frameworks for Policy and System Analysis

Social intercourse tends to increase with the urbanization, specialization, and team production associated with a commercial society, so it is natural that some virtues and ethical dispositions increase in relative importance. The life among specialized strangers typical of cities would tend to make some kinds of problems more commonplace than in the countryside, which would make the development of rules to deal with them more useful and of greater intellectual interest. In addition, as useful rules of conduct were developed, they would be seen as practical aids to life, as in Franklin. In many cases, they would also be supported by market forces through higher profits, salaries, and better opportunities.

If the aim of personal ethics can be thought of as the “good life,” the aim of civil ethics can be thought of as “the good society.” A connection clearly exists between the two insofar as a good society is one in which all (or most) have opportunities to pursue and realize a good life.

That Western societies were changing during the eighteenth and nineteenth centuries was obvious to most observers, but whether the changes were improvements or not was less so. As a consequence, interest in evaluating the relative merits of social systems was stimulated among philosophers and social scientists and the voters.

#### B. Utilitarian and Contractarian Approaches to Policy Analysis

The evaluation of the relative merits of major policy reforms and social systems requires a normative theory that is independent of the systems themselves. Utilitarian philosophy conceptually provided such a method for evaluating both major and minor reforms based on their effects on

## Ethical Foundations of the Commercial Society: Chapter 9

### Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

aggregate utility. However, as Spencer pointed out, doing so in practice was not always possible.

A more operational version of utilitarianism was worked out by Arthur Pigou in the early twentieth century, and was subsequently widely adopted by economists and policy analysts. Alfred Pigou's creation of a more operational utilitarianism came to be called "welfare economics," in part because it focuses on economic welfare, broadly interpreted.

Another response to the criticisms of Spencer and others was the reinvigoration of contractarian philosophy, a line of reasoning that had been ignored for much of the nineteenth century. Several innovations in contractarian analysis were developed by John Rawls and James Buchanan in the second half of the twentieth century.

All three of these innovations tended to support the commercial society, albeit with reservations. Public policy and institutional analysis from both perspectives were increasingly focused on whether and how one might make commercial societies more attractive, rather than to supplant or curtail them.

## II. Early Contractarianism

The contractarian theory of legitimate governance and civil ethics emerged during the seventeenth and eighteenth centuries. It directly and indirectly influenced the policy positions of relatively well-educated and influential men during those centuries and continued to do so during the next centuries as well, although with diminished force.

Contractarian analysis begins by noting advantages that can be realized by living in a community. These they suggest are sufficient to cause men and women to voluntarily form such communities and adopt laws to constrain the behavior of all who live in them. The laws adopted and organizations developed to refine and implement them are legitimate

because the parties affected by them have all agreed to the governing laws, form, and procedures of government.

That an ideal community is analogous to a private club has a number of implications about its basic laws (as with civil and criminal law) and its procedures for making public policies (democratic or not, representative or not, etc.). Some rules and procedures can be ruled out, because free men and women would never have accepted them. Others may be deemed legitimate (proper), because they tend to advance broadly shared interests by all the members of the community of interest.

### A. Proto-Contractarians: Real and Proposed Social Contracts of the Early 1600s

The idea that societies should be grounded in the agreement of persons living in them was clearly "in the air" during the early seventeenth century. For example, many of the emigrant groups that formed new communities in the North American colonies did so via formal contracts of the founding members. The Mayflower Compact is the most famous of these formal agreements, but numerous other communities were founded with similar documents in colonial North America, as with the present day cities of Providence and Newport Rhode Island. These communities were initially small enough that the family heads of all members and immigrants could formally agree to the founding constitutions.

A few years later, an English reform group called the Levelers called for a social-contract based government for of all England. Their various drafts of an "Agreement of the People" proposed a variety of major reforms in the 1640s including equality before the law, the end of monopoly privileges, and regular elections to the parliament.<sup>1</sup> These were radical proposals for a society based on family, town, and corporate privileges--and thus their name was initially coined as a rebuke to such reforms.

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<sup>1</sup> Political reforms included more democratic governance, a reduction in noble privileges, and more equal protection of the law. The latter is evidently why they came to be called the "levelers." Several of the drafts supported freer trade than existed in England in this period.

The ideal of a contract-based society was subsequently formalized and deepened in books by two highly regarded philosophers of the same century, Thomas Hobbes (1651) and John Locke (1689).

#### **B. The Hobbesian Social Contract: Escaping from the State of Nature**

The point of departure for the most philosophical theories of contract-based societies is “the state of nature.” This hypothetical original setting is one in which men are completely free to do what they want. Men and woman in a state of nature may abide by natural law of the Grotius variety or not. They may try to take another’s possessions or lives, or protect their own, rather than attack others.

The result of such unlimited freedom according to Thomas Hobbes is a nasty world, as characterized by the Hobbesian dilemma in chapter 6. To escape from the resulting war of man against every other, that mutual advantage would induce all the persons living in a given territory to agree to a social compact in which some natural liberties are surrendered to a community-wide organization, its government.

The **final Cause**, End, or Design of men, (who naturally love Liberty, and Dominion over others,) **in the introduction of that restraint upon themselves**, (in which we see them live in Commonwealths,) is the **foresight of their own preservation**, and of a more contented life thereby;

that is to say, of **getting themselves out from that miserable condition of War**, which is necessarily consequent (as hath been Shown) to the **Natural Passions of men**, when there is no visible Power to keep them in awe, and tie them by Fear of punishment to the performance of their Covenants...

**The only way to erect such a Common Power, as may be able to defend them from the invasion of**

**Foreigners, and the injuries of one another, and thereby to secure them in such sort, as that by their own industry**, and by the fruits of the Earth, they may nourish themselves and live contentedly; is, to **confer all their power and strength upon one Man, or upon one Assembly of men, that may reduce all their Wills, by plurality of voices, unto one Will...**

This done, **the Multitude so united in one Person, is called a Commonwealth**, in Latin *Civitas*. **This is the Generation of that great Leviathan**, or rather (to speak more reverently) of that Mortal God, to which we owe under the Immortal God, our peace and defense.

**This is more than Consent, or Concord; it is a real Unity of them all**, in one and the same Person, made by Covenant of every man with every man, in such manner, as if every man should say to every man, **"I Authorize and give up my Right of Governing myself, to this Man, or to this Assembly of men, on this condition, that thou give up thy Right to him, and Authorize all his Actions in like manner."** [Hobbes (1651/2004). *Leviathan* (pp. 93-96).]

According to Hobbes, citizens would agree to permanently transfer all of their natural authority to a king or parliament as a means of realizing the far better life associated with the safer and more sophisticated society that would emerge after human and natural resources are directed away from war toward more productive uses.<sup>2</sup>

A commonwealth emerges from the consent of the governed. Nonetheless, for Hobbes, the social contract was a once and forever agreement that established the procedures for choosing policies (one man or one assembly). Similar remarks are found two centuries later in Kant’s theory of governance (xxxx). Most subsequent contractarians, however, disagreed with Hobbes on this point. They argued that the voluntariness of

<sup>2</sup> Hobbes thus indirectly critiques the military ethos as leading to an inferior form of life and society.

the social contract implies sharp limits on the policies that a government could legitimately adopt.

#### C. The Lockean Social Contract: Agreement among Free Men

Locke (1689), like Hobbes, also begins with the natural state, but he regards the natural state to be less nasty than Hobbes did.

MEN being, as has been said, by nature, all free, equal, and independent, no one can be put out of this estate, and subjected to the political power of another, without his own consent.

**The only way whereby any one divests himself of his natural liberty, and puts on the bonds of civil society, is by agreeing with other men to join and unite into a community** for their comfortable, safe, and peaceable living one amongst another, in a secure enjoyment of their properties...[Locke (1689 / 2011). *Second Treatise of Government* (p. 37). ]

[T]he enjoyment of the property he has in [a natural] state is very unsafe, very unsecure. This makes him willing to quit a condition, which, however free, is full of fears and continual dangers: and **it is not without reason, that he seeks out, and is willing to join in society with others, who are already united, or have a mind to unite, for the mutual preservation of their lives, liberties and estates, which I call by the general name, property.** [Locke (1689 / 2011). *Second Treatise of Government* (p. 42).]

[Government's] **power, in the utmost bounds of it, is limited to the public good of the society.** It is a power, that **hath no other end but preservation,** and therefore can **never have a right to destroy, enslave, or designedly**

**to impoverish the subjects.** [Locke (1689 / 2011). *Second Treatise of Government* (p. 51).]

Locke argues that the voluntary nature of a commonwealth implies that governments have clear duties and a limited domain of authority.

Voluntariness implies limited rather than absolute government. With respect to public policies, it implies that some policies are legitimate and others not. For example, a government may not enslave its citizens or impoverish them. To do so would be a violation of the social contract--and thus immoral. People would never voluntarily agree to live under a slave master.

Note that the contractarian argument suggest that property rights, broadly interpreted, arise from a social contract and serve everyone's interest. Property is not theft from this perspective, but rather a method of reducing conflict within a community and promoting its development, more or less as Aristotle had argued.

The signing of a social contract implies that all signatories expect to be at least as well off after the community is founded as before.

Although there are societies that arguably began with a formal social contract, contractarian analysis tends to be abstract. Imaginary agreements are analyzed rather than real world social contracts or unanimous votes. Does a political institution or public policy appear to benefit nearly everyone or not? If the benefits are very broad and obtained at a reasonable cost, then the institution or policy could be said to have a contractual basis. If not, an institution or policy can be said to be unjust or illegitimate.<sup>3</sup>

The contractarian tradition faded in the late eighteenth century with the rise of utilitarianism. However, interest in the contractarian approach to institutional choice and reform continued among political theorists. It was re-energized in the second half of the twentieth century through the

<sup>3</sup> American students should recognize that much of the language of its revolutionary leaders and founding fathers resembled that of the early contractarians, Locke in particular, but also later ones including Thomas Paine and Thomas Jefferson. Europeans should note that many of the European constitutions adopted during the eighteenth and nineteenth centuries began with contractarian sentiments.

influential writings of the philosopher John Rawls and economist James Buchanan.

#### D. Utilitarian Critiques of Early Contractarianism

The general framework of utilitarianism has already been introduced and many of its implications for personal behavior elaborated, although not its implications for public policy. When applied to public policies, the normative question remains, as always: “Is aggregate utility increased by the policy or not?” This is a question that in principle should be answered in the affirmative for every single policy.

Note that Contractarian logic is largely compatible with the utility principle. A policy that is adopted unanimously tends to increase aggregate utility. Every one that casts a vote expects to be better off (otherwise at least they would vote against the policy at issue). There may be mistakes, as in any part of life, but as long as the anticipated results are on average realized, the result of a unanimous vote, as with an ordinary exchange, increases aggregate utility.

Utilitarians, however, do not require everyone to benefit from a policy, nor do they require the fiction of a contract, only that the benefits are greater than its costs in terms of happiness and pain. Both these differences, simplify their analysis and allow sharper conclusions about both individual policies and actions. Contractarians, in turn, criticize utilitarians by suggesting that utility itself is a fiction, an imaginary index, and argue that immoral conclusions can result from utilitarian reasoning that ignores basic human rights, especially over public policies that do not advance shared interests.

Some utilitarians also question the value of agreement, per se. Bentham, for example, argues that agreement is not sufficient to demonstrate that aggregate utility will be increased by a new policy or policy reform.

**All the world may be agreed; but upon what is this agreement founded?**

Ask each one his reasons. You will find a strange diversity of sentiments and principles: you will find it not only among

the people, but among the philosophers. Is it lost time to seek for an uniform base of agreement upon so essential an object?

**The agreement which exists is only founded upon prejudices; and those prejudices vary according to times and places,**

**We appeal, then, here to the principle of utility: it confirms the decisions of prejudice wherever they are just; it annuls them wherever they are pernicious.**

Bentham, Jeremy (2013-08-02). *Collected Works of Jeremy Bentham* (KL 8180-8190).]

Bentham suggests that agreements provide useful evidence about the magnitude of social utility only if they are based on sound reasons, rather than customs, passions, or false beliefs. A policy based on false beliefs may appear to be beneficial but generate great harms. Agreements might also be reached to impose harm on others outside the community of interest, as in a time of war.

Bentham also suggests that evaluating policies and institutions by their effects on aggregate utility tends to promote rationality.

The necessity of furnishing a sufficient reason for every law, would be a preservative against a blind routine on the one hand, and a restraint to every thing arbitrary on the other. **If you are required to state your reason for each proposition, it will be necessary to think, instead of to copy; to possess clear ideas, and to admit nothing without proof.**

There will no longer be any opportunity for preserving in the laws fantastic distinctions, useless regulations, unnecessary restraints: **inconsistencies will become too prominent: the disproportion between good and evil will become too offensive.** [Bentham (2013-08-02). *Collected Works of Jeremy Bentham* (KL 12963-12967).]

## Ethical Foundations of the Commercial Society: Chapter 9

### Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

Part of the appeal of utilitarian over contractarian analysis is its appearance of precision, generality, and relative simplicity. It provides a clear meaning for vice and virtue, right and wrong, it provides a clear-sounding ethical indicator of the relative merits of public policies and institutions.

Utilitarian policies are also easier to implement than contractarian ones. For example, economic analysis implies that elimination of a tariff tends to increase consumer welfare, although it reduces profits and tax revenues. All the persons who benefit from such barriers to trade would have to be compensated for their losses under the contractarian norm in order to generate unanimous agreement. For utilitarians, it is sufficient to demonstrate that consumers gain more utility than the others lose.

The clarity of utilitarian analysis is, however, easy to exaggerate. As noted by Spencer and many others, utilitarian analysis of long term policies also benefits from stable personal assessments of pleasure and pain (utility) in the period of interest. Given this, one also needs to know the consequences of policy choices and the utility levels of all affected individuals.

### III. Commerce Supporting Norms and Reform in the Nineteenth Century

The policy agendas of contractarians and utilitarians in the nineteenth century were, nonetheless, in broad agreement on a wide variety of policy and constitutional issues in Europe and North America during the late eighteenth and the nineteenth centuries.

They were both secular, inclusive, analytical approaches to public policy. They tended to be anti-privilege, pro-free trade, pro-education, and pro-infrastructure--all positions that tended to open up opportunities for a far broader cross section of individuals, families, and organizations than medieval rules had allowed.

To promote the changes in public policy and law necessary to advance those ends, many utilitarians and contractarians were politically active. They wrote politically oriented editorials and commentary, they founded policy

oriented magazines and newspapers, and engaged in lobbying campaigns in public (with organized speeches and debates), and in private, often supported by sympathetic persons in government. They wrote books and gave public lectures that promoted those policies. In some cases, utilitarian reformers ran for higher office.

Their reform efforts were reinforced by shifts in other private ethical theories that favored industry, thrift, and honesty and tended to be less supportive of "unearned" privileges.

Together with new theories of the self regulating nature of markets and technological advance, these cultural shifts generated increasingly broad support for policies of government neutrality and noninterference during the nineteenth century: the separation of government and religion, and the separation of government and economics. Government privileges and preferences for churches, families, towns, and particular markets were gradually reduced or eliminated, partly because these were deemed unethical or unjust by voters. These and related policies also tended to support the commercial society, by lowering barriers to entry, lowering transport costs, and increasing the quality of the labor force.

As these reforms became long-standing policies, more extensive trading networks emerged and larger enterprises were organized. The broader markets allowed new large scale production methods to be profitably employed. Capitalism in the modern sense emerged.

This is not to say that changes in civil ethics alone were sufficient to induce the policy reforms that produced the commercial society. These were normally reinforced by practical economic interests in profits and partisan interests in winning and holding office. It bears noting, however, those pragmatic allies of reform also tended to use moral language whether narrowly or in utilitarian public welfare forms.

Pragmatists did not simply argue (at least in public) that policy X will make me richer or more powerful, but that policy X will advance general interests. Desired reforms would make us all better off by creating better opportunities for the pursuit of happiness (more employment opportunities) than the status quo allowed. Opponents would appeal to

tradition or argue the opposite, that proposed policies will make us all worse off.<sup>4</sup>

Pragmatists would not have used arguments grounded in ethics unless those arguments were thought to be more persuasive than pure self-interest arguments. And, they would not have been persuasive unless many voters and policy makers had already internalized the norms used to argue in support of particular policies.<sup>5</sup>

The political and economic effects of the nineteenth-century reforms were obvious. In 1800, elections in Europe were not very important or open procedures. By 1900, as a consequence of the efforts of liberal reformers, elections and elected officials had become the dominant part of the policy-making process in most of Western Europe and an increasingly important one in Japan. The same could be said of political and economic reforms in Canada, Australia, and New Zealand. Competitive elections had been important in the United States from fairly early in its colonial days, but even there property requirements were dropped, and subsequently race and religious qualifications.

A significant shift from agriculture to commerce took place during the same period, partly driven by technological advances in farming, but also by expanding opportunities in the commercial sector. For example, in the United States farm employment accounted for about 75% of employment in 1800, but only about 40% in 1900, a period in which farming itself had become more productive and commercial.<sup>6</sup>

The commercial society did not emerge overnight. Instead, it was the result of a long process of (mostly) innovation, persuasion, and political horse trading in which both personal and civil ethics played a central role.

Shifts in personal ethics had made commerce a more virtuous mode of life. Shifts in economic theory implied that more open markets tend to produce greater income and wealth than the heavily regulated mercantilist societies. Shifts in civil ethics favored equality before the law, just deserts, and progress over privilege and tradition. The new arguments shifted the balance of moral authority away from the traditionalists and toward the liberal reformers. In this, both the new institutions and more extensive markets of late nineteenth-century could be said to have moral foundations.

That shifts in norms were critical in this process is implied by the fact that only the countries that liberalized their political institutions industrialized in the nineteenth century. And, that only the countries that industrialized became liberal democracies. Where constitutional liberals lost the public and private policy debates, as in China and Turkey, industrialization was more limited and democratization even more so.

#### IV. Ethical Support for Markets in the Twentieth Century

The legislative successes of the liberals in the nineteenth century did not imply that normative challenges to the commercial society completely

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<sup>4</sup> Examples of liberal reforms include: (i) making land sales easier to undertake (the enclosure movements of Europe), (ii) reductions of internal trade barriers (including the end of local monopolies), (iii) educational reforms that increased the size (and arguably the average diligence) of the literate labor supply, (iv) reductions in international trade barriers, and (v) reductions in the cost of creating limited liability corporations. These reforms were adopted gradually and often combined with others that also tended to promote the development of dense networks of exchange and specialization. Significant political reforms were adopted during the same period, including expanded suffrage and increased roles for Parliaments. See Congleton (2011).

<sup>5</sup> This is a useful first approximation that will be used throughout the remainder of the volume. The theory of second best (Lancaster xxxx) implies that some movements toward the ideal may actually reduce aggregate utility, rather than increase it. Similar local nonconvexities may also occur under other ethical theories as well.

<sup>6</sup> See Weiss (2007) in Gallman and Wallis (Eds.) (2007). England's commercial sector was relatively larger in this period, but the shift from agriculture to commerce was similar, falling from about 40% of labor to about 10% in 1900 (Clark 2002). Much of the service sector in this period could be regarded as non-commercial insofar as servants were paid in kind rather than in cash (e.g. with room and board).

## Ethical Foundations of the Commercial Society: Chapter 9

### Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

disappeared or that the norms of that society were in a long run equilibrium of the Spencer variety. History did not end in 1910.

During the twentieth century, the commercial life, with its salaried employment, purchase of both necessities and luxuries in markets, large scale enterprise, continuing innovation, and uncertainties became the new normal in the West. "Hiring oneself out for wages" and the purchase of the necessities of life were largely taken for granted. As the commercial society became the normal mode of life, the natural conservatism of normative systems (traditionalism) tended to provide support for the new lifestyles and institutions. Former lifestyles were increasingly difficult to imagine.

Unfortunately, as specialization increased, the self regulating features of markets emphasized by Smith and Bastiat, turned out to involve relatively large fluctuations in the demand for goods, services, and labor. These business cycles naturally undermined arguments favoring the commercial society and lead to a variety of anti-commercial theories on the far right and left. The new uncertainties associated with business cycles and innovation called forth new policies such as unemployment insurance and central banking.

Appeals to the norms and lifestyles of the medieval period remained commonplace. Although no longer mainstream, they often helped to anchor new ethical theories on the right and left. Among these were communist and fascist theories of the good life and good society that tended to narrow the scope for voluntary exchange and innovation, experimentation, and democratic politics. These were top-down rather than bottom-up systems, somewhat in the spirit of More's utopia. Several major twentieth century wars arguably had their roots in ethical challenges to the commercial society.

To counter the new ethical arguments, philosophically oriented economists, political scientists, legal scholars, and philosophers developed new arguments in support of liberal economic and political institutions and their associated patterns of life. The feasibility of alternative visions of the ideal society were called into question. Could centrally run societies achieve as much material comfort as that associated with a commercial society? Was it plausible that the rulers of such regimes were likely to have internalized

the personal and civil ethics necessary to support those societies, or were they more likely to be power seeking pragmatists?

New more operational versions of utilitarianism were developed and new contractarian theories. Major twentieth century developments are illustrated with four influential scholars: two prominent early twentieth century economists, one a left liberal and the other a right liberal, and two late twentieth century contractarians, one a left liberal philosopher and the other a right liberal economist.

#### A. Alfred C. Pigou (1877-1959)

Alfred Pigou's *The Economics of Welfare* (1920) provides a new utilitarian-based economic tool bag for what would come to be called welfare economics. Pigou was more critical of commerce than Spencer and Betham, but he provides new normative tools for thinking about the relative merits of the outcomes of various types of markets. Pigou argues that gross national product (the social dividend) can be used as a proxy for aggregate utility. He also argues in favor of limited redistribution, and provides a clear rationale for government interventions in markets to address externality and monopoly problems, analogous to those suggested by Mill. The latter was a challenge to the doctrinaire liberals of the Spencer variety in the early twentieth century, but arguably would make a commercial society more attractive than it would have been without such interventions.

Although much of Pigou's argument can be taken to be a critique of the commercial society, his analysis includes a strong defense of commerce and also largely takes such a commercial society for granted.

**The one obvious instrument of measurement available in social life is money.** Hence, the range of our inquiry becomes restricted to that part of social welfare that can be brought directly or indirectly into relation with the measuring-rod of money. This part of welfare may be called economic welfare.

**It is not, indeed, possible to separate it in any rigid way from other parts, for the part which can be**



## Ethical Foundations of the Commercial Society: Chapter 9

Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

**brought into relation with a money measure will be different according as we mean by can, “can easily” or “can with mild straining” or “can with violent straining.”** [Pigou (1920). *The Economics of Welfare* (KL 295-300).]

The preceding discussion makes it plain that any rigid inference from effects on economic welfare to effects on total welfare is out of the question. In some fields the divergence between the two effects will be insignificant, but in others it will be very wide.

**Nevertheless, I submit that, in the absence of special knowledge, there is room for a judgment of probability. When we have ascertained the effect of any cause on economic welfare, we may, unless, of course, there is specific evidence to the contrary, regard this effect as probably equivalent in direction, though not in magnitude, to the effect on total welfare;** [Pigou (1920). *The Economics of Welfare* (KL 438-443).]

GENERALLY speaking, economic causes act upon the economic welfare of any country, not directly, but through the making and using of that objective counterpart of economic welfare which economists call the national dividend or national income. **Just as economic welfare is that part of total welfare which can be brought directly or indirectly into relation with a money measure, so the national dividend is that part of the objective income of the community, including, of course, income derived from abroad, which can be measured in money.** [Pigou, (1920). *The Economics of Welfare* (KL 601-604).]

If gross national product (GNP) can be used as a proxy for aggregate utility, the greater the extent of the commercial society, the greater is aggregate utility, other things being equal. This was a new utilitarian basis for supporting the commercial society as a whole. The extent of commerce

itself is correlated with aggregate utility. The greater is commerce, measured in dollars, the greater aggregate utility tends to be.

This argument also had implications for public policy. A policy's effect on the size of the aggregate utility is likely to be directionally similar to its effect on GNP. If commerce is expanded by a policy, then aggregate utility is also likely to have been increased.

Having made a general argument in support of commerce, Pigou shifts his attention to various limitations of that argument, again from a utilitarian perspective. He next argues that the wealth and income that are generated by commerce tend to increase aggregate utility but not to maximize it. Commerce is a good system, but it may not be the best system possible.

For example, the logic of diminishing marginal utility implies that redistribution from the rich to the poor can increase aggregate utility, whenever it can be done without reducing GNP.

**Nevertheless, it is evident that any transference of income from a relatively rich man to a relatively poor man of similar temperament, since it enables more intense wants, to be satisfied at the expense of less intense wants, must increase the aggregate sum of satisfaction.**

The old "law of diminishing utility" thus leads securely to the proposition: **Any cause which increases the absolute share of real income in the hands of the poor, provided that it does not lead to a contraction in the size of the national dividend from any point of view, will, in general, increase economic welfare.** [Pigou (1920). *The Economics of Welfare* (KL 1561-1565).]

It is evident that, provided the dividend accruing to the poor is not diminished, **increases in the size of the aggregate national dividend, if they occur in isolation without anything else whatever happening, must involve increases in economic welfare.** [Pigou (1920). *The Economics of Welfare* (KL 1468-1470).]

## Ethical Foundations of the Commercial Society: Chapter 9

Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

Some of Pigou's arguments regarding the possibilities for increasing aggregate utility beyond that associated with market outcomes might be classified as socialist. For example, he argues that the government run some industries as well or better than private entities, as with utility companies. However, his argument nearly always aims to maximize the size of the economy, and in this sense takes for granted that economic activity is generally both useful and virtuous.

Although policy-orientated utilitarians often neglect the importance of internalized ethical dispositions, Pigou does not entirely do so, noting that what he refers to as the social virtues are imperatives for life in a community. As a utilitarian, he naturally emphasizes those that are most important for utilitarian outcomes: honesty and taking account of one's behavior on the entire community.

**As a member of a society with interests in common with others, the individual consciously and unconsciously develops the social virtues.**

**Honesty becomes imperative**, and is enforced by the whole group on the individual, loyalty to the whole group is made an essential for the better development of individual powers. **To cheat the society is to injure a neighbor.**

Pigou, A.C. (1920). *The Economics of Welfare* (KL 376-379).

Nonetheless, Pigou's analysis tended to shift the debate among utilitarians toward practical economic issues. If GDP is accepted as meaningful indicators for the good society, the main issues are those associated with increasing the scope of the commercial society. Some adjustments at the margin are called for, however, if the extent that aggregate utility can be further increased by promoting social virtue, internalizing externalities, and modest redistribution. What are the externalities that should be internalized? How much redistribution can be undertaken without undermining the social dividend? To what extent can government be expected to pursue utilitarian ends?

The appropriate roles for government among twentieth century utilitarians goes well beyond that advocated by many nineteenth century

liberals: maintaining law and order, a bit of infrastructure investment, and support for basic education.

### B. Ludwig von Mises (1881-1973)

Ludwig von Mises wrote *Liberalism* in during the mid 1920s in Austria, a period in which profound changes were taking place in the German speaking world. The royal systems of Germany and Austria were suddenly swept away at the end of World War I and replaced by new republican governments dominated by social democrats (most of whom could be considered left-liberals). Law and order broke down in many places as conservative regional governments resigned and were replaced with various types of radical reformers including communists. Markets were disrupted and ideological debates raged in parliaments and in the streets.

The parliamentary regimes of the royal period were revised and transformed into national governments. Their new leaders had never exercised significant policy authority before. The short term results were somewhat chaotic as fiscal and monetary policies generated hyper inflation and economic hardship. These results naturally undermined the arguments of German liberals and moderate social democrats, who had associated representative governance with good results, as it had been in its neighbors to the North and West.

Mises spent much of his career defending the market system and criticizing alternatives proposed by those he termed socialists. For Mises, this was a broad category of philosophers, politicians, and voters, who opposed private ownership of capital and often favored centrally managed economic systems. His arguments were less influential among economists and policy makers than those of Pigou in the English speaking world, although they had broad impact worldwide. His articulation of liberal principles and defense of what he refers to as capitalism were among the most persuasive and well known in the first half of the twentieth century.

He challenges many of Pigou's conclusions about redistribution, not by rejecting utilitarian arguments, but by arguing that changes in distribution of income or in fundamental market institutions such as the private ownership of land and capital would significantly reduce the national

## Ethical Foundations of the Commercial Society: Chapter 9

Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

dividend. One cannot simply assume that GNP will not be affected by such changes.

Those who advocate equality of income distribution overlook the most important point, namely, that the total available for distribution, **the annual product of social labor, is not independent of the manner in which it is divided.**

**The fact that that product today is as great as it is, is not a natural or technological phenomenon independent of all social conditions, but entirely the result of our social institutions.**

**Only because inequality of wealth is possible in our social order, only because it stimulates everyone to produce as much as he can and at the lowest cost, does mankind today have at its disposal the total annual wealth now available for consumption.** [Mises (1927). *Liberalism* (p. 31).]

As true of Pigou, his analysis spends relatively little time on private ethics and focuses on the social issues, especially those relative to the opponents of privately owned land and capital. Nonetheless, he suggests that the preservation of society requires self discipline and internalized civil ethics. His focus is entirely on civil ethics.

**Morality consists in the regard for the necessary requirements of social existence that must be demanded of each individual member of society.**

**A man living in isolation has no moral rules to follow. He need have no qualms about doing anything he finds it to his advantage to do, for he does not have to consider whether he is not thereby injuring others.**

**But as a member of society, a man must take into consideration, in everything he does,** not only his own immediate advantage, but also the necessity, in every action,

of affirming society as such. **For the life of the individual in society is possible only by virtue of social cooperation, and every individual would be most seriously harmed if the social organization of life and of production were to break down.**

In requiring of the individual that he **should take society into consideration in all his actions,** that he should forgo an action that, while advantageous to him, would be detrimental to social life, **society does not demand that he sacrifice himself to the interests of others.** For the sacrifice that it imposes is only a provisional one: **the renunciation of an immediate and relatively minor advantage in exchange for a much greater ultimate benefit.**

**The continued existence of society as the association of persons working in cooperation and sharing a common way of life is in the interest of every individual.** [Mises (1927). *Liberalism* (pp. 33-34). Ingram Distribution. Kindle Edition.]

**The observance of the moral law is in the ultimate interest of every individual, because everyone benefits from the preservation of social cooperation; yet it imposes on everyone a sacrifice, even though only a provisional one that is more than counterbalanced by a greater gain.** [Mises (1927). *Liberalism*. (p. 34).]

His argument lies between the pure utilitarian and the contractarian lines of reasoning. Society is to be taken into consideration in every action, not to maximize aggregate utility, but because everyone benefits from a subset of civil ethics and law, as argued by Locke.

He argues that private property including the private ownership of capital plays a central role in the social order that had emerged in the previous century, and therefore should be regarded as moral.

## Ethical Foundations of the Commercial Society: Chapter 9

Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

In seeking to demonstrate the social function and necessity of private ownership of the means of production and of the concomitant inequality in the distribution of income and wealth, **we are at the same time providing proof of the moral justification for private property and for the capitalist social order based upon it.** [Mises, (1927). *Liberalism* (p. 33).]

[The] return to the institution of free private ownership of the means of production is to be found in the fact that **an economic system serving the needs and purposes of man's life in society is, in principle, impracticable except on this foundation.** [Mises (1927). *Liberalism* (p. 69).]

Mises was opposed to government establishment of privileges, including those associated with market activities. He argues that equal treatment under the law is an important constitutional principle for the liberal social order of the early twentieth century Europe.

**There are two distinct reasons why all men should receive equal treatment under the law.** One was already mentioned when we analyzed the objections to involuntary servitude. **In order for human labor to realize its highest attainable productivity, the worker must be free, because only the free worker, enjoying in the form of wages the fruits of his own industry,** will exert himself to the full. The second consideration in favor of the equality of all men under the law is the maintenance of **social peace.** ... **Class privileges must disappear so that the conflict over them may cease.** [Mises (1927). *Liberalism* (p. 28).]

Although von Mises is often associated with contemporary libertarianism in the United States and is widely read by those at the more anarchistic end of the spectrum, he was not an anarchist as sometimes seems to be suggested by those readers, but a right-of-center liberal. With respect to anarchism, his argument parallels that of Hobbes and many

others. Mises simply updates and sharpens what critics of the nineteenth century referred to as “doctrinaire liberalism.”

**Liberalism is not anarchism, nor has it anything whatsoever to do with anarchism.** The liberal understands quite clearly that without resort to compulsion, the existence of society would be endangered and that **behind the rules of conduct whose observance is necessary to assure peaceful human cooperation must stand the threat of force** if the whole edifice of society is not to be continually at the mercy of any one of its members.

**One must be in a position to compel the person who will not respect the lives, health, personal freedom, or private property of others** to acquiesce in the rules of life in society. **This is the function that the liberal doctrine assigns to the state: the protection of property, liberty, and peace.** [Mises (1927). *Liberalism* (p. 37).]

Disagreements about the proper scope of government are clear in the Mises and Pigou analyses. Mises argues that government should be limited to the protection of property, liberty, and peace. Pigou clearly believes that governments can go beyond national defense and civil law to improve the operation of markets and moderate its least appealing results. Indeed, he believes that public utilities and other natural monopolies can be run by governments, by delegating their management to councils of experts.

Mises, in contrast, believes that governments have very limited ability to undertake such management for host of reasons. Mises suggests that the benefits of society--implicitly the commercial society--are greatest when governments authority is restricted to the domain suggested by Locke, Smith, Bastiat, and Spencer. This is partly because of the nature of democratic politics which tends to favor narrow over general interests.

There are a great number of parties, and each particular party is itself divided into various subgroups, ... **Each particular party and faction feels itself appointed to be**

**the sole champion of certain special interests**, which it undertakes to lead to victory at any cost.

**To allot as much as possible from the public coffers to “our own,” to favor them by protective tariffs, immigration barriers, “social legislation,” and privileges of all kinds, at the expense of the rest of society, is the whole sum and substance of their policy.**

[Mises (1927). *Liberalism* (p. 171).]

It bears noting that Pigou and Mises agree that the commercial society is a powerful system for increasing material welfare. Mises stresses its beneficial effects on every individual, Pigou those on aggregate utility. Both support democratic governance, although in Mises' case with significant constitutional constraints. Both also note that internalized ethics play an important role in society. Without such internalized rules, societies and markets work less well.

Their differences are also important, as the heated policy debates of the twentieth century affirm.

#### V. The Rebirth of the Contractarian Civil Ethics

After WWII, two major scholars began casting doubt upon the logic and appeal of utilitarian analysis. One was among the best known philosophers of the post war period, John Rawls, the other won a Nobel Prize in economics for his efforts, James Buchanan. Both criticized the conclusions reached by utilitarians and the foundations of their ethical system(s). Both emphasized agreement as the foundations for a good or just society, rather than the maximization of aggregate utility. Both emphasize a two stage mode of analysis, what Buchanan terms the constitutional and post constitutional periods.

The rebirth of contractarianism was arguably a consequence of weaknesses in the utilitarian approach. Utilitarians who were troubled by the measurability of utility, might for example, be drawn to contractarianism insofar as voluntariness is an important indicator of the relative merits of alternative states of the world. Political theorists who are

not necessarily advocates of markets may also be drawn to it for its clear statement about the ultimate foundations and limits of state actions.

The early contractarians were among first to suggest that the interests of all should be taken into account when evaluating institutions. The agreement of all members of a community is the ultimate test of legitimacy of governments and their associated systems of policy selection. The grounding laws of society are delegations of authority from individuals to organizations created to advance their interests.

As argued by Hobbes and Mises, individuals are willing to sacrifice their liberties in exchange for others doing the same thing. The result is a far better society that advances the interests of all.

Many policy making procedures and laws cannot be justified on those grounds. Thus, contractarian analysis was initially used to criticize a variety of medieval practices and to rationalize particular laws and legal institutions, as in the work of Montesquieu (1748) and Blackstone (1766). It was against such scholars and natural rights theorists that Bentham aimed many of his early philosophical arguments.

The problems of utilitarian analysis were not entirely neglected, but the contractarian alternatives were even less attractive in part because the theory was moribund. The rebirth of contractarian analysis was partially an effort to restate and better articulate the contractarian perspective and partly an effort to better contrast its strengths with the weaknesses of utilitarianism.

#### A. John Rawls (1921 - 2002)

John Rawls is best known outside philosophy for his classic book, *A Theory of Justice* (1971). In that book he proposes an alternative to the utilitarian framework, one is similar in spirit to the early contractarian analysis, but different in manner of argument and emphasis. He argued that an alternative to utilitarianism is necessary because it lacks a defense of fundamental human rights or of democratic government.

His approach was quite original although his argument and conclusions take account of the insights from many of the philosophers that we have

## Ethical Foundations of the Commercial Society: Chapter 9

### Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

already surveyed. In 1999, Rawls published a revised edition of the *Theory of Justice*, which reflected his responses to more than two decades of critiques and extensions of the original. This is the edition used for the purposes of this chapter. It represents Rawls' final analysis and defense of his arguments. Some of his conclusions were softened in that version, including some with respect to his "maximin principle."

The aim of [my] **contract approach** is to establish that taken together they impose significant bounds on acceptable principles of justice.

**The ideal outcome would be that these conditions determine a unique set of principles; but I shall be satisfied if the suffice to rank the main traditional conceptions of social justice.** [John Rawls (1999) *A Theory of Justice*. Harvard University Press. Epub edition, page 14.]

Rather than rely on the Hobbesian natural state arguments of seventeenth and eighteenth century contractarians, he calls on readers to imagine that they do not know who he or she will be in the society that emerges after basic principles and institutions are chosen. From behind this "veil of ignorance," one is tasked with assessing the relative merits of the alternative institutions (or meta norms for such institutions, e.g. principles of justice) based on the lives associated with every possible position in the society that would emerge from particular institutional choices.

Rawls assumes that individuals are rational and have both private and moral interests, a representation similar to that used in part II of the present volume. He argues that a consensus would emerge from his recommended thought process about the core institutions of society.

The **principles of justice are chosen behind a veil of ignorance.**

This assures that no one is advantaged or disadvantaged in the choice of principles by the outcome of natural chance of the contingency of social circumstances. ...

The symmetry of everyone's relation to each other, as rational beings with their **own ends** and **capable, I shall assume, of a sense of justice.** [Rawls (1999) *A Theory of Justice*. Harvard University Press. Epub edition, page 9.]

Individuals have both narrow interests and an interest in moral or ethical ends, that is, to say a sense of justice. In the context of the veil of ignorance, this may be taken to be similar to Grotius' characterization of natural law or Spencer's characterization of a moral sense. Everyone shares this sense of justice and thus consensus emerges from this process of reflection.

From behind the veil of ignorance Rawls argues that all persons would agree to three principles, which would be used to evaluate alternative political and economic institutions. The three principles that he suggests are:

**Each person is to have an equal right to the most extensive scheme of equal basic liberties** compatible with a similar scheme of liberties for others.

**Social and economic inequalities are to be arranged so that they are both** (a) reasonably expected to be to everyone's advantage, and (b) attached to positions and office open to all. [John Rawls (1999) *A Theory of Justice*. Harvard University Press. Epub edition, page 50.]

Note that two of the three are equal liberty provisions similar to those argued by Spencer and Mill. The third concerns economic inequalities, the area in which Rawls' conclusions are the most famous outside of philosophy.

Rawls' list of basic liberties include freedom of speech and assembly, liberty of conscience, freedom from arbitrary arrest and seizure and the right to hold personal property, among others. The equal liberty principles takes precedence over the equality principle (p. 53).

**The basic rights and liberties guarantee equally for all citizens the social conditions essential for adequate**

## Ethical Foundations of the Commercial Society: Chapter 9

Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

**development and the full and informed exercise of their two moral powers**, their capacity for a sense of **justice** and their capacity for a conception of the **good**. [John Rawls (1999) *A Theory of Justice*. Harvard University Press. Epub edition, page xiv.]

Equal liberties enable individuals to develop their moral capacities, in a manner analogous to Aristotelian investments in virtue. Although argued from an original perspective, Rawls' conclusions echo those of Aristotle, Grotius, Spencer, and many others.

The equal liberty and distributional principles, in turn, are used to assess the relative merits of fundamental institutions such as markets and democracies. With respect to politics, Rawls reaches conclusions in the spirit of Hobbes, Locke, Pigou, and contemporary welfare economics. Governments have a role in providing law and order, pure public goods, internalizing externality problems, and addressing problems associated with monopoly.

For the purposes of this volume it is important to note that Rawls believes that markets would always play a role in the distribution of goods and services. He notes many attractive properties of markets.

[T]he **ideal market process, as distinct from the ideal political process conducted by rational and impartial legislators, is that the market achieves an [Pareto] efficient** outcome even if everyone pursues his own advantage. [John Rawls (1999) *A Theory of Justice*. Harvard University Press. Epub edition, page 314.]

[A] **further and more significant advantage of a market system is that, given the requisite background institutions, it is consistent with equal liberties and fair equality of opportunity.** .. There is **no necessity for comprehensive direct planning. Individual households and firms are free to make their decisions independently**, subject to the general conditions of the economy.

[However] there is presumably no general answer to this question since it depends in large part upon the traditions, institutions, and social forces of each country... [John Rawls (1999) *A Theory of Justice*. Harvard University Press. Epub edition, page 237-240.]

He also acknowledges problems with democratic rule and, perhaps surprising, reaches a conclusion similar to that of von Mises regarding the importance of morality in political decisionmaking.

A just constitution **must rely to some extent on citizens and legislators adopting a wider view** and exercising good judgment in applying the **principles of justice**. [John Rawls (1999) *A Theory of Justice*. Harvard University Press. Epub edition, page 315.]

An internalized theory of justice is a precondition for just or fair public policy. Ethics is more important for the politics of a good society than it is for markets.

With respect to markets as systems for distributing the social dividend, however, he is less clear because of implications of the second principle. Here he argues that inequality would be acceptable only if it increased the welfare of the least advantaged, what many refer to as the difference or maximin principle.

Assuming the framework of institutions required by equal liberty and fair equality of opportunity, **the higher expectations of those better situated are just if and only if they work as part of a scheme which improves the expectations of the least advantaged** members of society. [John Rawls (1999) *A Theory of Justice*. Harvard University Press. Epub edition, page 63.]

### B. James M. Buchanan (1919-2013)

James Buchanan was trained as an economist in the era before mathematics and statistics became central parts of graduate training. From the beginning of his career, he very concerned about philosophical issues,

## Ethical Foundations of the Commercial Society: Chapter 9

Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

political institutions and methods for evaluating the merits of institutions and policies. With respect to the later, he argued against utilitarian and social welfare economics of his day, challenging them on a variety of grounds including the instability and incompleteness of preferences and the non-commensurability of preferences orderings during periods in which they are stable.

One cannot simply add utility levels or functions up. Consequently, there can be no deference to utilitarian experts on matters of constitutional design or public policy analysis.

His work includes many statements, extensions, and defenses of the contractarian approach to normative theory. His approach differs from previous contractarians in that he like Rawls rarely appeals to the Hobbesian state. Rather, he takes that status quo as the point of departure and asks the question, how can we all be made better off. He nonetheless uses models rather than surveys to determine whether there are mutual advantages to adopting or revising grounding laws and public policies--the rules of the game--under which an economy and society will subsequently emerge.

The opposing **contractarian conception of law and politics** is based squarely in the rejection of any claim that the institutions and the policies that are good for the community are “out there” waiting to be discovered by experts or anyone else.

The rules for living together - the basic law and political structure - are, quite literally, made up or created in some participatory process of discussion, analysis, persuasion, and mutual agreement. In this conception of social order, the constitution, inclusively defined, emerges from agreement among those who must abide by the constraints contained within it.

**The constitutional stage, which involves both law and politics, is understood and described best in terms of an exchange of agreements among participating**

**members of the community. Persons agree to constraints on their own liberties in exchange for comparable constraints being imposed on the liberties of others.**

**The metaphor is that of a social contract.** And agreement itself serves as the criterion for goodness or truth. That rule or political action that is **good for the community of persons is defined** by that option upon which **agreement** is reached rather than some imagined correspondence with an independently discoverable object of community search.

**To the contractarian the question posed is: Could the existing set of rules have emerged from the agreement among all parties who are currently subject to them?**

Or, in individualistic terms, the proper question is: Could I have agreed to the set of rules that the existing political-legal structure represents? [Buchanan and Congleton (1998) *Politics by Principle not Interest*. Cambridge University Press, p.4-5.]

Buchanan, like Rawls, also relies upon a “veil” to motivate agreement, although in his case the veil is the natural uncertainty associate with long run planning, rather than an imaginary initial position used to identify core principles of justice. He argues that the long term nature of constitutional decisions tends to generate uncertainty simply because our ignorance about the future. What is potentially knowable about the future is also bounded because of human free will and influential surprise events.

**The veil of ignorance and/or uncertainty offers a means of bridging the apparent gap between furtherance of separately identified interests and agreement** on the rules that conceptually define the "social contract." Potential contractors must recognize that the basic rules for social order - the ultimate constitutional structure - are explicitly chosen as permanent or



## Ethical Foundations of the Commercial Society: Chapter 9

### Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

quasi-permanent parameters within which social interaction is to take place over a whole sequence of periods.

This temporal feature, in itself, shifts discussion away from that which might take place among fully identified bargainers and toward discussion among participants who are unable to predict either their own positions or how differing rules will affect whatever positions they come to occupy. [Buchanan and Congleton (1998) *Politics by Principle not Interest*. Cambridge University Press, p.4-5.]

Buchanan was less willing than Rawls to commit to particular divisions of responsibilities between markets and politics. Although he had strong classical liberal disposition, he thought it presumptuous to declare his “preferences” to be the “truth.” Rather, he regarded his opinion about the matter as simply one of many that would be taken account of during constitutional negotiations.

In his last book length treatment of constitutional issues, Buchanan argues that all citizens should be treated in the same manner by government policies, a position similar to that of Kant with respect to universal law. However, basis of the generality argument is quite different. Given a democratic polity, with its possible majoritarian cycles, generality can make everyone simultaneously better off by reducing the frequency and extent of those cycles.

He argues that acceptance of the generality principle in politics has implications about the line between politics and markets.

**The economists' normative argument in support of the superior efficiency of resource allocation generated in non-politicized markets is reinforced by the argument concerning the political efficacy of the generality norm.**

[The Generality] norm, if operative as a constitutional constraint, ensures that the “all-encompassing interest,” reflected in **the maximal value of produce**, as evaluated by the preferences of participants and subject to the transfer

proviso discussed later, will be chosen as preferred by any coalition in a position of collective authority.

In effect, **the constitutionalization of generality in treatment indirectly amounts to the constitutionalization of market allocation in settings in which public goods and externalities are not present.**

[James M. Buchanan and Roger D. Congleton [1998] *Politics by Principle not Interest*. Cambridge University Press, p.76.]

Note that Buchanan, like Rawls, accepts the conclusions of welfare economics with respect to public goods and externalities, although not the methodology of their analysis. These are areas in which citizens might agree to task governments with responsibilities to intervene in markets.

However, if there are no externalities or public goods problems, then the commercial society is not to be interfered with. To do so in such cases would violate the generality principle, a conclusion that is not so different from Spencer’s criticism of the early regulatory and transfer programs of England.

## VI. A Contractarian Illustration: Choosing Institutions from Behind the Veil

### A. A simple representation of institutional choice

Suppose that there are three types of persons and four types of institutions. Suppose also that one can characterize the net effect of an institution on a particular person with a single number, which can be regarded as either personal wealth or utility. In this case, the overall effect of the three institutions can be represented as a triple, with a single number representing the consequences of individuals of the three types (a, b, c).

A. (5, 5, 5)

B. (8, 7, 6)

C. (11, 8, 5)

D. (20, 5, 2)

As a point of departure, assume that the status quo is the egalitarian one, society A, and that only four types of society are possible, A, B, C, and D. Now imagine a constitutional convention among forward looking rational persons interested in improving their society through major reforms. If each persons know exactly their payoff (utility or wealth) in the society that emerges from each set of institutions, there is agreement about the need before, but agreement about the best reform. Individual “a” prefers institution D, “b” prefers institution C, and “c” prefers institution B. They agree that reform is a good idea, but disagree completely about the best course of reform, because each is affected differently by the reforms that are possible.

#### B. Buchanan and the Veil of Uncertainty

From the Buchanan perspective, agreement is nonetheless possible. All three individuals will be uncertain about the long run effects of the reforms, because the future is difficult--indeed nearly impossible--to predict accurately. Thus decisions about institutions are always shrouded by a veil of uncertainty. This, Buchanan argues, tends to promote consensus.

To see this, suppose that everyone at our hypothetical constitutional convention regards it equal likely that they would be persons, a, b, and c. If the persons voting at the convention are all risk neutral, they would agree that institution D is the best, because it **maximizes the average payoff**:  $9 > 8 > 7 > 5$ . If the three voters were **somewhat risk averse they might opt for C instead**, because it has a higher average payoff than the other two, but the worst case outcome is no worse than the original egalitarian institution.

#### C. Rawls and the Veil of Ignorance

The Rawlsian perspective is similar to the Buchanan one, although the focus is on shared philosophical dispositions, rather than outcomes per se. Suppose that those dispositions, as argued by Rawls, tend to support the difference principle, under which inequality is tolerable only if it benefits the least advantaged (or is expected to)--assuming that the equal liberty principle is satisfied. In that case, **institution B** would be the preferred one, because it maximizes the welfare of the least advantaged person in society.

Note that that institution might also have emerged under the Buchanan approach if voters were very risk averse and so adopted maximin institutions. In Rawls, however, it is the agreement about distributional justice behind the veil rather than uncertainty about the outcomes that generates the agreement.

Uncertainty in the outcomes themselves would also matter, but through effects on voter expectations about the consequences of institutions. If the above results are simply one of the possible outcomes associated with the four legal and political settings, one could imagine agreements that produced any of the three insofar as the expected outcome is better for the least well off than the particular realization listed, although not the specific outcome that emerged.

One can also imagine settings in which the justice principle agreed to was different from the difference principle, in which case another institution might emerge as the best one for this society of three.

#### D. Contrast with Utilitarian and Egalitarian Reasoning.

Under utilitarian reasoning, one selects among these institutions based on the sum of the utility payoffs. If the above numbers are utilities, institution D is clearly the best:  $27 > 24 > 21 > 15$ . Although both the Rawlsian and Utilitarian frameworks tend to favor relatively equal outcomes when a wider array of institutional possibilities exist, they do not under the assumed limited range of alternative institutions used in this illustration. Note the contrast with strong egalitarian norms under which the status quo may be regarded to be the best (A), insofar as equal outcomes are always better than unequal ones.

Of course other factors than final outcomes might also affect the voting over institutions. For example, the processes that generate the outcomes under the four institutions may be more or less attractive, more or less compatible with private or civil virtue, tend to reinforce or undermine virtue, etc. However, the illustration is sufficient to demonstrate points of agreement among contractarians and disagreements with utilitarian analysis.

#### VII. Conclusions: Ethics and the Assessment of Major Institutions

Policy reforms along with changes in personal ethics and technological advance arguably propelled the emergence of the commercial societies during the nineteenth and twentieth centuries. Those reforms, in turn, were propelled by a combination of ethical or ideological interests and self interest.

Moral support for the general direction of reform was provided by politically active groups that favored more open market and political systems for a variety of personal ethical, natural rights, and utilitarian reasons. Their legislative and constitutional successes during the eighteenth and nineteenth centuries caused their many policy disagreements to shift to center stage in the in the twentieth century.

Many of the defenders of commerce were utilitarians, insofar as aggregate utility, satisfaction, or welfare played key roles in their analyses. A handful of others used new versions of contractarian arguments. Still others relied on evolution and natural-rights based arguments.

A new normative issues addressed by twentieth century liberals is the extent to which governments should actively redistribute wealth from rich to poor. Modest social insurance systems were adopted throughout the West in the late nineteenth and early twentieth centuries, often by right-of center governments. That this was done, implies that some degree of concern existed over the uncertainties of life generated by markets, innovation, and business cycles. However, social insurance is not redistribution, simply risk sharing.

Whether governments should go beyond these relatively modest programs was very widely debated over most of the century, with major expansions of social insurance programs taking place during the 1960-85 period throughout the west. Mainstream arguments for and against such policies often revealed both a broad acceptance of commerce as a proper

form of life, but also ethical concerns over the efficiency and justice of market outcomes.

Arguments for more extensive social insurance programs were grounded in moral philosophy, some of which tended to undermine ethical supports for a life in commercial society. For example, a subset of utilitarians (Pigou) and contractarians (Rawls) advocated major programs of redistribution. Arguments against proposals for major programs of redistribution emphasized both the morally attractive features of markets and the negative consequences of such programs. Market rewards were argued to reflect just deserts. The utility gains associated with market exchange and innovation were greater than those associated with centralized control or uniform outcome. Economic incentives encouraged more work and innovation and thus higher incomes and aggregate utility. Moreover, democratic politics were not likely to implement utilitarian or egalitarian programs.

That constitutional liberals were decisive in twentieth century debates is suggested by the fact that social insurance programs were expanded, but relatively little redistribution took place from rich to poor beyond the implicit discounts for public services and insurance generated by progressive income taxation. Markets continued to determine most of the distribution of income and wealth. That left liberals were more influential than right liberals is suggested by the very large expansions of social insurance programs between 1960 and 1985.<sup>7</sup>

The ethical case for commerce in the twentieth century is based on civil ethics, rather than personal ethics. Although persons can be more or less ethical in their commercial dealings, it is taken for granted that commerce is either a virtuous or ethically neutral area of life in the commercial societies that fully emerged in the twentieth century.

The issues that came to center stage in the twentieth century were system civic ones. Is the commercial society was the best that is presently feasible for human beings, and if not how can it be improved?

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<sup>7</sup> Congleton and Bose (xxxx) provide evidence that the 1960-85 expansion of the welfare state reflected changes in the norms (ideologies) of moderate voters throughout the West in that period..

## Ethical Foundations of the Commercial Society: Chapter 9

### Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

Support for the grounding institutions and policies of a commercial society and for commerce itself was provided by new generations of utilitarians and contractarians. A few philosophically oriented economists, such as Mises, noted that markets were inherently compatible with civil virtue. Others considered commerce to be an effective social system for generating both material comforts and the resources necessary to advance aggregate utility.

Both contractarian and utilitarian support for markets tended to become more conditional, as externality and public goods problems were clearly identified. At the same time, economic theory increased in rigor and obtained a more fine-grained understanding of how contemporary commercial societies operated. The models themselves came to be incorporated into, or taken for granted, in many philosophical analyses of the relative merits of alternative regulations and civil laws, as in Rawls and Buchanan.

In addition, new statistical methods provided new evidence that affirmed the importance of economic institutions for economic development. For the most part, this empirical evidence simply affirmed the common sense of nineteenth century constitutional liberals. Commercial societies emerge when legal systems protect property rights, and allow persons and organizations to enter markets and career paths, to adopt new technologies, and to create new markets. The effectiveness of such institutions is reinforced by the existence of a willing and reasonably trustworthy workforce.

Contemporary utilitarian and contractarian analysis use economic analysis and statistical evidence to draw conclusions about the good society. It was during the twentieth century that the limitations of what Smith termed the system of natural liberty were thoughtfully analyzed. This analysis began with Pigou's analysis and continued through the century to that of Rawls and Buchanan. Markets are a mean to end in such theories rather than an ultimate end.

Their conclusions, perhaps surprisingly, provided new moral support for many of the core institutions of a commercial society, while suggesting policies that improve them from the perspective of persons living in them. The material and social success of the Western market-based societies relative to other systems in place during the century became incontrovertible by the end of the twentieth century.

The extent of markets was not simply the result of well-defined property rights. Tradable property rights exist in many but not all noncommercial societies, but not the right to choose career paths, enter new markets, or adopt innovations. Noncommercial societies have many formal and informal barriers to exchange, some of which are based on internalized ethical dispositions. The "proper" role of women, for example, are more restricted in noncommercial societies.

#### A. Contractarian and Utilitarian Support for Commerce

The correlation between what Pigou called the national dividend and aggregate utility was broadly accepted by economists and policy makers in the twentieth century. The higher an individual's personal income the more possibilities for increasing material welfare existed. The higher national income, the greater the average person's ability for increasing material welfare. This association allowed alternative national policies to be compared with a single measurable index rather than an imaginary aggregate of happiness.<sup>8</sup>

The Pigovian approximations for aggregate utility became the mainstays of normative economics and policy analysis in the new fields of macroeconomics, development, and public economics. His utilitarian basis for assessing policies and institutions based on GNP were often forgotten, as the normative case for greater wealth was increasingly taken to be intuitively obvious. In this respect, wealth itself became a norm--commerce as the ultimate end rather than a means to an end--in much policy analysis.

The new contractarians challenged the validity such aggregate measures on several grounds. The idea that one could add up utilities is

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<sup>8</sup> Happiness indices were constructed late in the twentieth century based on survey evidence and were employed by a few researchers. See for example, Frey and Stutzer (xxxx).

methodologically inappropriate, if utility is regarded as simply an analytical convenience, rather than a model of the human mind or happiness.

Moreover, utilitarian analysis often, although not always, leads to conclusions that conflict with moral intuitions and also with ideas at the heart of contractarian political theory. For example utilitarianism can be used to rationalize killing a healthy person for his “body parts” in order to keep a dozen people alive. Such conclusions violated what Spencer and Rawls called the equal liberty principle. It is unlikely that any potential signatory to a social contract would agree to such a rule.

That consequences are important for both these theories of civil ethics made social science increasingly central to their analysis. In this manner the positive--what are the consequences of an action or policy--became increasingly intertwined with the normative--are the consequences good or bad.<sup>9</sup> The separation remained useful insofar as positive analysis can be extended by the common efforts of persons who disagree about the nature of right and wrong, but agree about how to separate fact from fiction.

#### **B. Welfare Economics and the Scope of the Commercial Society**

The experience of the twentieth century demonstrated that the proper extent of government interventions in markets varies with moral theory and natural theory. The latter implies that theories of government as well as theories of economic activity are necessary to fully determine the appropriate dividing line between the public and private sectors, because it is not only important to understand the types of market outcomes that tend to emerge, but also the types of public policies that will be adopted to address them. The moral and constitutional lines between the governing and private sectors remains an important issue, as in Mill's time.

Most utilitarian analysis implicitly or explicitly assumes that governments are staffed by utilitarian policy makers, rather than with self interested men and women. If governments always adopted policies that

reduced aggregate utility, utilitarians would argue against most government interventions, as Spencer and Mises did.

The next two chapters review some of the core geometric tools of welfare economics and use them to illustrate how externalities, public goods, and political failures influence utilitarian and contractarian conclusions about the appropriate scope of government interventions in markets. It also briefly reviews related models of politics and the sorts of aggregate utility reducing policies that might be adopted.

These new “economic” tools, perhaps surprisingly, tended to strengthen the case for market supporting policies and institutions, as did Pigou's initial analysis. Being fundamentally grounded in utilitarian and contractarian normative theories, the results may also be said to have ethical foundations.

#### **C. The Incremental Path to the Better Society**

If the ultimate aim of virtuous action is to improve one's character so that one can live the “best” life possible for a human being, the ultimate aim of virtuous policy choice is to achieve the “best” society possible. However, the laws and dispositions that make life in society most attractive are unlikely to emerge in one grand revolutionary step. Rather, it is likely to emerge, as private virtue does, through years of experimentation and practice. Just as theories of the good life may improve, so may theories of the good society. Indeed, if Spencer's reasoning is accepted, both personal and civil ethics are moving targets, because of the evolutionary pressures both are subject to. The best life in the best society is a long run ideal, not a choice for the present. All others are subject to improvement.

Nonetheless, the idea that a best life or best society exists can be used to simplify one's ethical decision making. For example, given a rough characterization of the “best life,” any action that tends in that direction should be undertaken. Given a rough characterization of the best society, any change in law, policy, or grounding institutions that moves society

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<sup>9</sup> Unanimous agreement would also tend to select policies and institutions that are consistent with the utility principle. Nonetheless as noted above, some utilitarians would reject such agreements as indices of social utility when they are based on passions or fallacious beliefs. To a contractarian such as Buchanan, it would be presumptuous to assume that you knew more about another's “true” interests than they themselves do.

toward the “best” society can be regarded as an improvement. An implication of Spencer’s evolutionary reasoning is that a “better” society is normally the best that can be hoped for.

How to identify improvements is not entirely obvious. Just as private actions can be undertaken to advance both practical and virtuous goals, the laws and policies of a community can be reformed to advance both practical and ethical ends. Most legal and regulatory reforms have a broad range of impacts on individuals, some pleasant and others unpleasant, some may conflict with personal ethics or internalized civil norms, while supporting others. Practical and ethical aims may also conflict. Human ignorance also limits one’s ability to precisely account for all the affects of policy changes.

In communities, this difficulty is increased by the need to acknowledge and take into account the conflicting ethical and practical goals of individuals residing in the communities of interest.<sup>10</sup> Even in monasteries the devout may differ with respect to interpretations of divine texts. In a cosmopolitan urban or national settings, such disagreements include both fundamental differences in religion and secular philosophies, as well as conflicting practical interests.

The search for core principles of civic ethics is partly an effort to reduce the complexity of the problem to be solved. For example, Kant’s insistence on universal laws, reduces the domain of public policy choices to ones that apply equally to all members of a community. Contractarian and majoritarian theories restrict the appropriate manner of choosing among policies. Utilitarian logic provides a single index that can in principle be applied to all policy choices.

These major strands of contemporary philosophy suggest that what Locke somewhat hesitantly argued was a separate sphere of moral philosophy has become the main focus of several important philosophical schools of thought. That civil ethics is so difficult is one of the reasons that so many have written so much about the nature of the best society and the institutional and policy reforms that take us toward it.

#### D. Policy Analysis as an Exercise in Civil Ethics

The aim of part III, however, is not to analyze the relative merits of alternative theories of civil ethics or to provide a theory of the theory of civil ethics, but to examine their conclusions about market-relevant public policies and institutions. Public policy analysis clearly falls in the domain of civil ethics and conclusions reached about the virtues of one policy relative to another clearly affect policy choices, at least at the margin.

This is not to say that personal ethics are never used to evaluate policies. For example, the persons that occupy persons working for governments, public policies, or systems of government. If policy makers are themselves ethical then their policies are likely to be as well, in the sense that they are dishonest, imprudent, or otherwise despicable. Nonetheless, to the extent that such evaluations are not about self-improvement, but about appropriate behavior for members of a community, ethical assessments of public policy fall in the domain of civil ethics.

Nor is it to say that practical matters are irrelevant. Engineering analysis clearly contributes to infrastructure debates and have implications both for the mode of construction and location of a project. Economists and political scientists have tried to determine the consequences of both existing public policies and reforms of those policies. Such analyses are important whenever the consequences of public policy are of interest to policy makers.

That ethical considerations are also often important for policy decisions should also be clear. For example, in contemporary Western society, taxes are collected via general rules, albeit with exceptions, rather than simply gathered up from the rivals and enemies of those presently in power. How revenues “should” be raised, who “should” be taxed, and how progressive a tax system “should” are all ethical questions. To say that practical consequences matter is simply to say that one’s own internalized ethics includes consequences among the factors that one considers when determining the answers to such questions. Insofar as civil ethics aims for

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<sup>10</sup> Such conflict may also occur internally for eclectics who have internalized rules of conduct that are not entirely self consistent.

the good or best society, they tend to be largely driven by consequences, given a theory or vision of the good society.

In democracies, competition for the support of voters tends to produce policies that advance the median voter's interests. What those interests are, however, has been left open in most rational choice models, or assumed to be similar to those of consumers of private goods and services. However, clearly ideas of fairness, appropriate behavior, and duty are among the many dimensions of voter interest. Indeed, it is arguably the latter that brings voters to the voting booth.

That voters disagree about the nature of the good society and the best means to head towards it tends to bring ethical dimensions into public policy debates.<sup>11</sup> Public debates and lobbying campaigns nearly always stress ethical implications of the legislation to be voted on or candidate to be elected. Clearly, lobbyists and public relations firms realize that voters tend to oppose projects and candidates that they believe to be unethical, and support those they regard to be virtuous, other things being equal.

As fully encompassing theories of civil virtue and duty become more widely internalized, more and more of public policy becomes a matter of civil ethics. Among contemporary utilitarians and environmentalists, virtually every possible policy has ethical implications: from the color and placement of stop signs to the best methods of law enforcement and national defense, from the standards for washing machines to the placement and extent of interstate highways, from the appropriate progressivity of income taxation to the best rate of subsidization for octane increasing additives for gasoline. This is not to say that only virtuous policies are ever adopted, but that ethics plays a very broad and significant role in public policy debates, elections, and subsequent policy making.

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<sup>11</sup> A perverse consequence of this in the United States, in combination with voter ignorance, is that legislation with formal titles or names often have ones that imply their opponents are engaged in immoral or uncivil conduct when they oppose it.

### Appendix: To be shifted to chapter 10 or 11

#### E. Social Normative Theories and Ideologies

As in the case of private ethical theories, some ideologies are more likely to support market activities than others. For example, the liberalism of the nineteenth century supported market activity by reducing regulation and monopoly privilege, and by encouraging low and unobtrusive taxation. In contrast, the medieval order had supported monopoly privilege and often used tariffs and sales of monopoly power to limit competition and innovation in a variety of markets. Trade from a medieval normative perspective could not be trusted to markets, in part because it tended to undermine public morality, drawing persons away from public service and church duties. Trade from a royal pragmatist perspective was simply another source of deference, power, and revenues.

In the twentieth century a variety of social normative theories emerged that were highly critical of market outcomes including ones favoring central planning (communism and fascism) and more moderate ones concerned with environmental quality and equality of income. Others normative innovations were more supportive, as with Hayek's theory of spontaneous orders and Schumpeter and Rand's theory of heroic and innovative capitalism, as opposed to crony capitalism. Moreover, long standing theories were often applied in new ways that had implications for the "optimal" extent of markets, as with contractarianism (Rawls xxxx, Buchanan xxxx) and utilitarians (Pigou xxxx and Friedman xxxx).

Normative theories were often combined with positive theories to create more or less all encompassing ideologies. The conclusions of consequentialist ethical theories often change when scientific breakthroughs occur, and this also has changed some of the conclusions reached about the relative merits of market-based outcomes and processes. Consequentialist ethics are often society wide in their considerations and include conclusions about what might be called the good society--but private ethical theories

may also be generalized to characterize a good society, as was done by More in his book on Utopia.

#### F. Ethical Influences on the Selection of Public Policies

Both private and social normative theories can affect policies through direct effects on the policymakers themselves and indirect ones on the choice settings in which policymakers make their decisions.

Dictators themselves may have moral theories that encourage or discourage particular policy choices. They have internalized religious norms or secular ethics. Their purpose in office may be to advance god's or the people's will. They may have internalized socialist or liberal beliefs. Private property, may for example, be regarded as evil or good. Dictators also need the support of their military to continue in office and so will be inclined to reward military virtues such as bravery or loyalty, perhaps more than they themselves regard them. Similarly, the support of a society's dominant religious organization(s) is often useful, which may induce pragmatist leaders to espouse religious beliefs they do not have and to subsidize churches and their property through tax privileges and subsidies.

In democracies, office holders have to win elections to remain in office. The need for voter approval naturally induces candidates for office to take account of the ethical sentiments of their potential voters. Politicians who appear to be moralists themselves may command additional support from other moralists in their electoral districts, because they expect them to make the "right" choices whether in public or in private. Contrariwise, scandals--violations of ethical duties--is often a reason for shifting one's support from one candidate to another. The appearance of propriety is important, when ever one's electorate has a significant number of morally motivated voters. As a consequence, even pragmatic politicians will make moral declarations and attend ceremonies favored by their supporters.

In addition to these influences on policy makers with given interests, efforts may be made to change those interests through directly or indirectly persuasive campaigns. For example, arguments against slavery in the early nineteenth century were nearly all grounded in ethics, rather than economics--both social and private. They were sufficiently persuasive that



## Ethical Foundations of the Commercial Society: Chapter 9

### Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

an ancient institutions was outlawed throughout most of the world during that century, which in Europe at that time required the votes of elected members of parliament, nobles, and a royal assent. Similar ethics-based arguments were also used to expand suffrage and open up both domestic and international trade in Northern Europe, although in the latter case, economic were as important as ethical arguments.

Prudent officeholders will deliberate on the choices before them and act in a manner consistent with moderation and temperance. Contrariwise, imprudent leaders will act on impulse, take needless risks, and be apt to adopt policies that are neither moderate nor temperate. The results of policies chosen by good men thus tends to be better--at least on average--than those chosen by bad men, other things being equal, where better here means more consistent with their voters' normative assessment of policies and outcomes.

Such conclusions may seem a bit naive to contemporary analysts, but it should be kept in mind that the overwhelming mass of policy decisions are made in private, often secret, deliberations and that most of those decisions will be little known to the public, regardless of the extent of their interest in public affairs. From a private ethics perspective, the process of policy formation is that which is implicitly judged, rather than the policies one by one. A wise and good man can be trusted to select good policies, that is to say, such leaders select policies that are virtuous, e.g. consistent with private ethics.<sup>12</sup>

That a good deal of political advertising in contemporary democracies concerns the character of the men and women running for office rather than their policies, especially in polities that rely upon first-past-the-post elections to select officer holders, suggests that many voters use private ethics to select policymakers.

This selection process is most evident in primary elections, where candidates differ little by policy and voters can do little more than “size” the man or woman up relative to their alternatives. Such evaluations evidently focus on competence and integrity of the candidates. However, this evaluation process is evidently also commonplace among independent voters in general elections who make their decisions about candidates one at a time, rather than vote along party lines.

The policy positions of candidates can also be assessed a voter's ethical system. For example, if one follows the golden rule--do on to others as you would have do onto you--then one can try to imagine the consequences of a particular policy and determine whether it satisfies that reciprocity condition. Is the result one that those initiating it would have found desirable, had they been directly affected by the policy or not? Other private norms might also be used to assess the relative merits of policy, such as justice or fairness. Perhaps the most obvious of such policies are “sin taxes” and other “temperance” related policies, although many others exist as well.<sup>13</sup>

Contractarian reasoning also tends to support infrastructure projects such as roads, canals, and railroads because of their very broad general

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<sup>12</sup> A model of moral voting behavior and evidence of morality-driven policy choices in the United States are developed in Congleton (xxxx). See Gene xxxx (xxxx) for evidence on the effects of religion-based ethics in the United States with respect to state policies on abortion.

<sup>13</sup> Note that such a process is consistent with what political scientists refer to as identity politics. Candidates whose internalized norms are similar to those of particular voters will be supported by those voters. In this case, however, it is not simply because candidates are “like me,” but because their virtues are like mine. See (xxxx) for an overview of identity politics.

## Ethical Foundations of the Commercial Society: Chapter 9

### Choosing among Systems: Contractarian and Utilitarian Perspectives on the Good Society

benefits and because they tend to extend markets. The benefits of such expansions, for most contractarians implies that such projects have essentially universal benefits--albeit at a cost that should not be ignored. Policy by policy net benefits for all are not necessary, but the full fiscal package should produce net benefits for all affected parties, not simply a majority, powerful interest group, or national aristocracy.

That there is no single position in either school is itself noteworthy, and suggests that social ethics may have less definitively to say about this than proponents of particular solutions would imagine in the absence of very strong assumptions about reactions to incentives and other feasibility conditions.

disagreement is about the nature of the choice is about individual actions, grounding laws, moral rules, complex societies, or every aspect of human life. Another is the sort of government that will implement the policies recommended by normative analysis. This is an age old debate that stretches from Rawls and Buchanan back through Aristotle and Plato.