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## Market and State: The Perspective of Constitutional Political Economy

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# Market and State: The Perspective of Constitutional Political Economy<sup>\*</sup>

by

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**Abstract:** The paper approaches the “market versus state” issue from the perspective of constitutional political economy, a research program that has been advanced as a principal alternative to traditional welfare economics and its perspective on the relation between market and state. Constitutional political economy looks at market and state as different kinds of social arenas in which people may realize mutual gains from voluntary exchange and cooperation. The working properties of these arenas depend on their respective *constitutions*, i.e. the rules of the game that define the constraints under which individuals are allowed, in either arena, to pursue their interests. It is argued that “improving” markets means to adopt and to maintain an economic constitution that enhances *consumer sovereignty*, and that “improvement” in the political arena means to adopt and to maintain constitutional rules that enhance *citizen sovereignty*.

JEL classification: D60, H10

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## 1. Introduction: Market and State

The question of what should be left to the spontaneous coordination of economic activities in markets and what should be subject to deliberate coordination by government or “the state” is an issue that has been a central concern of economists since Adam Smith, and it is at the heart of the current political debates on the crisis of the welfare state and its need of reform. Any answer to the question of the appropriate division of labor between market and state must, explicitly or implicitly, employ, on the one hand, a normative criterion against which the performance of market processes and political processes can be judged and compared and, on the other hand, theoretical assumptions about their factual working properties.

Over the course of the history of their discipline economists’ perspectives on where the demarcation line between market and state ought to be drawn have undergone certain changes, reflecting changes in their interpretation of the appropriate normative standard as well as changes in their theoretical understanding of the nature of market processes and political processes. As far as the mainstream of economics is concerned these changes in perspective were essentially variations, though, within the boundaries of two fundamental principles that constitute the paradigmatic identity and continuity of economics. These are, on the one side, its *normative individualism*, broadly understood as the presumption that the welfare of the individuals concerned represents the relevant standard against which market and state are to be judged, and, on the other side, its *methodological individualism*, broadly understood as the presumption that market processes and political processes are to be explained, in the final analysis, in terms of the actions and interactions of individual human beings. These two principles have been the, often more implicit than explicit, paradigmatic guidelines of economic inquiry, even if they have not always been consistently applied nor always been interpreted in exactly the same manner.<sup>1</sup>

This paper approaches the “market versus state” issue from the perspective of constitutional political economy, a research program that grew out of the tradition of Public Choice theory and that sees itself as a paradigmatic alternative to traditional welfare economics. My main purpose is to show how constitutional political economy differs from standard welfare economics in its outlook at the respective roles that markets and

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<sup>1</sup> I am aware of the fact that there has been an extended debate on the various meanings that can be, and have been, ascribed to the notions of normative and methodological individualism. It is beyond the scope of the present paper to comment on this debate. The definitions given above seem to me to be broad enough to avoid many of the more specific issues that are at stake in the noted debate. In Vanberg 1975 I have discussed in considerable detail the issues surrounding the principle of methodological individualism. For a more recent treatise on the subject see L. Udehn 2001.

governments play in coordinating human actions. As I shall argue, the difference between the two approaches is due to certain differences in their normative and theoretical presumptions, in particular in their respective versions of normative and methodological individualism.

## **2. Constitutional Political Economy: The Economics of Rules**

Constitutional political economy can best be described as the economics of rules.<sup>2</sup> It is a research program that was mainly initiated by the work of James M. Buchanan (Brennan and Buchanan 1985; Buchanan 1990), but draws on other important sources as well, such as, in particular, F.A. Hayek's thoughts on the limits of knowledge and the reason of rules (Vanberg 1994a: 109ff.). It is part of the broader spectrum of approaches in modern economics that can be summarily described as the *new institutional economics* (Van den Hauwe 2000) and it has an important, but internationally little known, forerunner in the research program of the Freiburg School of law and economics.<sup>3</sup>

By contrast to the Walrasian tradition in economics that commits itself to exploring the working properties of a hypothetical world populated by perfectly rational homines oeconomici, constitutional economics starts from the recognition that the human agents that populate the world of our experience are imperfect agents, with limited knowledge and limited mental capacities.<sup>4</sup> Its principal focus is on the working properties of alternative rule regimes or, in Hayek's words, on how the *order of rules* affects the resulting *order of actions* (Hayek 1969). And it is on the practical question of how people can improve the socio-economic-political arrangements within which they live by adopting better "rules of the game." The game metaphor is deliberately emphasized in order to draw attention to the fact that, just as in an ordinary game – say soccer – the playing of the game is critically dependent on the rules of the game, so it is in the "games" of our socio-economic-political life. Such rule-focused research perspective is, to be sure, not entirely novel in economics. It can be traced back to Adam Smith's concept of political economy as "the science of a legislator" (Smith 1981: 486), a science that can provide guidance to those who are to choose the rules

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<sup>2</sup> For general overviews of the field see G. Brennan and A. Hamlin 1998; J.M. Buchanan 1987; V.J. Vanberg 1998b; L. Van den Hauwe 1999.

<sup>3</sup> On the close affinities between constitutional political economy and the much older research tradition of the ordoliberal Freiburg School see Vanberg 1988. The research program of the Freiburg School of Law and Economics (Vanberg 1998a) was initiated by economist Walter Eucken and jurist Franz Böhm in the 1930s at the University of Freiburg in Germany. Mainly because of the historical circumstances of the time, and because the relevant literature was published almost exclusively in German, the ideas of the Freiburg School had little impact internationally, and they had no direct bearing on the development of constitutional political economy.

<sup>4</sup> Nobody has argued more persistently than Hayek that it is because of the incurable limitations of our factual knowledge and of our cognitive abilities that we need to rely on rules in order to successfully cope with the problems we face, in our personal lives as well as in our interaction and cooperation with others (Vanberg 1993: 181f.; 1994a:111ff.).

for a society.<sup>5</sup> Yet, it is a perspective that has largely been forgotten within mainstream neo-classical economics. In reemphasizing a rule- or institution-focused perspective constitutional economics is in close affinity to similarly oriented approaches in modern economics such as, in particular, the above noted new institutional economics. Its distinctive feature is, not least, its central concern with the practical issue of how rules and institutions may be “improved” to the mutual benefit of the human agents involved.

As a *theoretical science* constitutional economics seeks to provide insights into the systematic relation between the *order of rules* and the *order of actions*. As an *applied science* it seeks to provide answers to the question of what rules of the social game are conducive to peaceful human coexistence and mutually beneficial cooperation. As a theoretical science it is committed to *methodological individualism* in the broad sense that it seeks to explain social phenomena in terms of the actions of individual human beings and of the combined effects of their interactions and co-operative efforts. As an applied science it is based on a *normative individualism* in the broad sense that the individuals involved must themselves be respected as the ultimate judges on what qualifies as “good” or desirable in their social transactions and rule-arrangements and that, accordingly, the “legitimacy” of transactions and arrangements ultimately derives from their voluntary agreement.

That it is based, in the sense explained, on the principle of normative individualism does not make constitutional economics a “normative science,” if that is understood to mean that it specializes in stating normative claims rather than refutable empirical and theoretical conjectures. It simply means that, as an applied science, as a science that seeks to contribute to the solution of practical social problems, it chooses to concentrate its analytical interest on exploring the issue of how people can jointly improve the constitutional- or rule-arrangements under which they live, where “improvement” is strictly defined in terms of what the individuals concerned themselves regard as improvement. The arguments that the constitutional economist pronounces on this issue are not normative postulates but *conjectures* that are subject to the standard criteria of scientific inquiry. In philosophical parlance, as applied science constitutional economics pronounces *hypothetical* imperatives, or conditional recommendations, as opposed to *categorical* imperatives, or unconditional recommendations. It does not simply tell people what they should do, it informs people about what institutional provisions may help them to solve, to their mutual benefit, certain problems they face. Like

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<sup>5</sup> Referring to Adam Smith’s concern with the ‘science of legislation’ Hayek (1973: 4f.) notes in the Introduction to his treatise on “Law, Legislation and Liberty”: “One of the main themes of this book will be that the rules of just conduct which the lawyer studies serve a kind of order of the character of which the lawyer is largely ignorant; and that this order is studied chiefly by the economist who in turn is similarly ignorant of the character of the rules of conduct on which the order that he studies rests.” See also Hayek (1969: 172; 1978: 136).

the recommendations that any other applied science, like e.g. engineering, may provide, the constitutional economist's hypothetical imperatives are *conjectural* recommendations. They are of no relevance if the addressees at whom they are directed do not agree with the constitutional economist's diagnosis that they face a problem the solution of which would serve their common interest. And the recommendation is inadequate if the institutional provision suggested is de facto not a suitable means for solving the problem, or an inferior means compared to potential alternative measures.

### 3. Constitutional Political Economy and the “Gains-from-Trade”-Paradigm

James M. Buchanan's approach to constitutional economics starts from the notion that economics, in general, should be properly viewed as *the science of the gains from trade*, as the science that specializes in studying the means and ways by which people can reap mutual benefits from voluntary cooperation.<sup>6</sup> While the traditional focus of economics is on voluntary market-exchanges as the paradigm case of mutually beneficial social transactions,<sup>7</sup> constitutional economics extends, as Buchanan suggests, the “mutual gains from trade” notion to voluntary co-operation more generally understood, including arrangements for collective action, private and public (Buchanan 1979: 27ff.).<sup>8</sup> It focuses, in particular, on the question of how people may realize mutual gains by their *voluntary joint commitment to rules* (Buchanan 1991: 81ff.). Or, in short, constitutional economics complements the economist's traditional focus on *mutual gains from exchange* by inquiring into how people may realize *mutual gains from joint commitment*, i.e. from jointly accepting suitable constraints on their behavioral choices.

Ordinary economics is about *choice within constraints*. These constraints include not only the budget- and price-constraints explicitly accounted for in standard textbook economics. They also include the behavioral constraints, typically left implicit in economic

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<sup>6</sup> See, in particular, Buchanan's 1962 presidential address to the Southern Economic Association, “What Should Economists Do?,” reprinted in Buchanan (1979). Referring to this address Buchanan (1991: 31) notes: “My argument was that economics, as a social science, is or should be about trade, exchange, and the many and varied institutional forms that implement and facilitate trade, including all of the complexities of modern contracts as well as the whole realm of collective agreement on the constitutional rules of political society.”

<sup>7</sup> Buchanan (1979: 31): “The ‘market’ or market organization is ... the institutional embodiment of the voluntary exchange processes that are entered into by individuals in their several capacities.” - Speaking of “voluntary co-operation of individuals” as the “technique of the market place,” M. Friedman (1962: 13) notes: “The possibility of co-ordination through voluntary co-operation rests on the elementary ... proposition that both parties to an economic transaction benefit from it, *provided the transaction is bilaterally voluntary and informed*” (emphasis in original).

<sup>8</sup> Buchanan (1979: 32): “The task of the economist includes the study of all such cooperative trading arrangements which become merely extensions of the market as more restrictively defined.” – “I am simply proposing, in various ways, that economists concentrate attention on the institutions, the relationships, among individuals as they participate in voluntary organized activity, in trade or exchange, broadly considered” (ibid.: 36).



analyses, that are defined by the norms, rules and institutions enforced in the social environment within which individuals act. Constitutional economics focuses on *choice among constraints* (Buchanan 1991: 4f.). Its emphasis is on the fact that, even though the rules that prevail in historically evolved social groups or communities are largely beyond deliberate control and willful change, people can choose to change some of the rules under which they live and to adopt new rules that promise to make for a better game. In other words, while standard economic analysis focuses on how rational agents seek to be more successful in playing a *given game*, taking the existing rules of the game as datum, the constitutional economist's interest is in inquiring how people may be able to play *better games* by adopting superior rules.<sup>9</sup>

The claim that social transactions or social arrangements are “*socially beneficial*” can, from a Buchanan-type constitutional economics perspective, have no other meaning than that the transactions or arrangements are *mutually* beneficial, i.e. beneficial to all parties involved. Taking a consistently individualist-subjectivist outlook, Buchanan insists that what may count as “better” in social matters can ultimately only be judged by the persons involved themselves and that, therefore, the relevant test for what qualifies as a “better game” must be seen in the voluntary agreement of the parties involved (Buchanan 1960: 122). In the case of market exchange the economist's claim that both sides gain in terms of their own judgement can, in the final analysis, be based on no other evidence than the *voluntary agreement* of the parties to the transaction. The standard notion of the “efficiency” of market outcomes is, in this sense, ultimately derived from the presumption that they result from voluntarily agreed-on transactions. Constitutional economics proceeds on the simple argument that, as a matter of consistency, the same reasoning should be applied to all other forms of social cooperation, private and public. It insists that “efficiency” and mutual advantage can, in their case too, ultimately be diagnosed only on the ground that all parties voluntarily agree on the desirability of the respective arrangements.

Because of its emphasis on *voluntary agreement* as the relevant criterion for the “goodness” of social transaction or arrangements constitutional economics in the Buchanan tradition is often labelled *contractarian*.<sup>10</sup> Traditional economics may, in fact, also be characterized as “contractarian” insofar as its analytical focus is on *exchange contracts*, i.e. on

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<sup>9</sup> In pursuing this research program constitutional economics shares what Hayek describes as the chief concern of “classical Anglo-Saxon individualism”: “The chief concern of the great individualist writers was indeed to find a set of institutions by which man could be induced, by his own choice and from motives which determined his ordinary conduct, to contribute as much as possible to the need of all others” (Hayek 1948: 12f.).

<sup>10</sup> Buchanan (1991: 121f.): “Contractarianism ... can be interpreted as little more than an extension of the paradigm of free exchange to the broader setting. ... By shifting ‘voluntary exchange’ upward to the constitutional level of choices among rules, the consensual or general agreement test may be applied.”

voluntary agreements to exchange transactions, as means of mutual improvement. By contrast to the traditional focus on exchange contracts the focus of constitutional economics is on *constitutional contracts* or *social contracts*, i.e. voluntary agreements on rules, as such means. Its concern with constitutional or social contracts places constitutional economics in close neighborhood to the social contract tradition in moral philosophy, in particular modern contractarian approaches, such as John Rawls' *A Theory of Justice* (1971).

The fact that its focus is on the issue of *mutual gains* from voluntary co-operation and voluntary joint commitment does not mean, of course, that constitutional economics is blind to the fact that the social world offers opportunities for *unilateral gains* as well, and that self-interested agents have no *immediate* reason why they should abstain from taking advantage of opportunities to improve their lot at the expense of others. The constitutional economist points out, however, that among socially interdependent agents attempts to secure unilateral gains at the expense of others easily result in outcomes that are inferior for all parties involved, compared to what could be achieved if they would all commit to rules that exclude such "exploitative" strategies. In other words, the constitutional economist does not ignore the omnipresence of opportunities for gaining at the expense of others, nor does he ignore the temptation for self-interested agents to take advantage of such opportunities. His central argument is that mutually beneficial cooperation is a much more sustained source of gains, and that, accordingly, there are prudential reasons for human agents to seek to improve the "social games" they play by jointly committing to rules that encourage and facilitate voluntary cooperation while discouraging exploitative strategies.

To simply equate, as I have done in my above arguments, *social* and *constitutional* contracts is not entirely correct. Stated in more precise terms, constitutional contracts represent a subclass of social contracts. "Social contracts" more generally understood, namely in contrast to bilateral exchange contracts, can in fact take two forms, related to two different kinds of "mutual gains." They can be called, on the one hand, gains from *complex exchange transactions* and, on the other hand, gains from *constitutional commitments*. By complex exchange transactions I mean organized collective actions that serve to coordinate the contributions of constituents to the production of a good that benefits all members of the respective group, but that free-rider problems prevent from being produced privately. Under such conditions all parties can benefit from an arrangement that requires everybody to contribute under the condition that all others pay their share as well, - and collective organization is used as the instrument to implement such a complex transaction. The transaction is similar to an ordinary market exchange in that each participant receives a

benefit in return for a contribution. Its difference lies in the fact that the “give and take” occurs not by way of decentralized bilateral transactions, but requires simultaneous coordination of the contributions of all members of the benefiting group.

By constitutional commitments I mean organized collective action that serves to define and enforce the “rules of the game” to which the members of a group are subject. By jointly committing to suitable rules, i.e. by mutually agreeing to submit to the discipline of such rules, all members of a group may be able to realize gains that could not be had if they were not so constrained. The term “constitutional contracts,” as distinguished from “social contracts,” is used to refer specifically to such joint constitutional commitments. To have one’s own behavior constrained by constitutional commitments is a “price” worth paying in return for the corresponding constraints on all other members of the respective group, and collective organization is, again, the instrument for implementing such “exchange of commitments.” The typical instances where such exchange of commitment is mutually advantageous are social-dilemma situations in which individually rational, unconstrained choices generate a pattern of outcomes inferior to what might result if all participants were appropriately constrained in their choices. The benefits participants can expect from such constitutional commitments are not derived from *specific* anticipated outcomes, but are the *overall benefits* that result *over time* from having the continuing process of interaction and co-operation bound by suitable constraints.

#### **4. Constitutional Contracts: Two Kinds of Conjectures**

In dealing with the issue of how mutual gains may be secured from constitutional contracts as joint commitments to rules constitutional economists can advance two kinds of conjectures that must be carefully distinguished. On the one hand, they can advance conjectures about what changes in rules they presume to be mutually beneficial for all parties concerned. On the other hand, they can advance conjectures about what procedures or rules *for choosing rules* are more likely to result in the adoption of rules that serve the interest of everybody involved, instead of serving the interests of some at the expense of others. The distinction may appear somewhat subtle, yet it is of fundamental importance, because the two kinds of conjectures differ systematically with regard to the ways in which their validity is to be tested.

Buchanan (1960: 122) refers to the first kind of conjectures when he notes that the political economist’s “task is that of locating possible flaws in the existing social structure and in presenting possible ‘improvements’.” The validity of the conjectures that the constitutional economist may advance in this regard depends on whether or not the institutional reforms or

changes in rules that he presumes to be “improvements” are actually judged so by the very persons involved themselves.<sup>11</sup> And there can be only one ultimate test for whether this is the case, namely the voluntary agreement of all parties concerned on the proposed new set of rules.<sup>12</sup> Stated differently, if we use the term *constitutional interests* to denote individuals’ preferences with regard to the kind of rules under which they would wish to live the first kind of conjecture can be said to be about the *common constitutional interests* of the persons concerned. Based on his knowledge of the factual working properties of alternative rules, the constitutional economist can seek to identify rule-changes that he expects to benefit all persons involved and that he, therefore, may deem to be in their common constitutional interest. Yet, whether or not his expectation is true or false does, obviously, not only depend on the correctness of his theoretical assumptions about the working properties of the relevant rules, but also on what the persons themselves consider to be in their own interest. That is to say, as far as conjectures of the first kind are concerned, the agents themselves and not the observing analyst are the ultimate judges. The constitutional economist can provide information on the relevant working properties of alternative rules, and he can seek to correct erroneous beliefs that the agents themselves may hold in this regard. But it is only the agents themselves, and not the constitutional economist, who can, and must, ultimately judge under which among alternative rule-regimes they prefer to live, given their respective working properties.<sup>13</sup>

The second kind of conjectures is exemplified, even if in a very limited sense only, by arguments that invoke the role of a “veil of uncertainty” (Buchanan and Tullock 1962) or a “veil of ignorance” (Rawls 1971) as a device that induces self-interested agents to judge rules from an impartial perspective and that, thereby, increases the prospects that a group of individuals may come to agree on a set of rules that are in their common interest. By contrast to the first kind of conjectures, conjectures of this second type are not about the issue of what rules might be judged mutually beneficial by the persons involved. They are, instead, about the issue of what kinds of procedures for choosing rules are more likely than potential alternative procedures to result in the adoption of rules that are, in fact, mutually beneficial

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<sup>11</sup> Buchanan (1977: 137): “The observing economist can suggest ways and means through which improvements may be made by agreement among all parties, and the test of his hypothesis lies only in agreement itself.”

<sup>12</sup> Buchanan (1960: 114): “The problem for the political economist is that of searching out and locating from among the whole set of possible combinations one which will prove acceptable to all parties.”

<sup>13</sup> To the constitutional economist applies, in this sense, what Hayek (1960: 114) says about the “political philosopher”: “Though he must not arrogate himself the position of a ‘leader’ who determines what people ought to think, it is his duty to show possibilities and consequences of common action.”

and, therefore, acceptable to all parties involved.<sup>14</sup> In other words, conjectures of this kind are about the *factual working properties* of procedures or rules for choosing rules rather than about subjective evaluations of the persons concerned. Accordingly, while for the first kind of conjectures the addressees of the constitutional economist's proposals are, necessarily, the ultimate judges, the validity of the second kind of conjectures is not a matter of how rules are subjectively evaluated by the persons involved but of how they actually work out in practice.

"Veil-arguments" exemplify the second kind of conjectures in a rather limited sense only because of the restrictive assumptions on which they are based. There are, in particular, two types of assumptions that play a critical role in "veil-arguments," namely, on the one side, assumptions about the uncertainty or ignorance of the persons involved concerning their own "constitutional interests"<sup>15</sup> and, on the other side, assumptions about the extent of their "constitutional knowledge."<sup>16</sup> A more general approach to the issue of which procedures for choosing rules favor the adoption of rules that are in the *common constitutional interest* of all parties concerned has to account for the fact that in the world as it is rules have to be chosen by individuals who command only rather imperfect constitutional knowledge and who are well aware of their particular constitutional interests. Accordingly, conjectures about what procedures for choosing rules are more likely to result in the adoption of *impartial*, mutually beneficial rules must provide arguments for how the obstacles from constitutional ignorance and from partial constitutional interests can be overcome.<sup>17</sup>

## 5. "Gains-from-Trade"-Paradigm versus Maximization-Paradigm

Buchanan's argument that economics should be understood as the science of the gains-from-trade is explicitly directed against the "maximization paradigm" that has dominated the economists' mind set ever since Lionel Robbins' (1935: 16) definition of economics as the

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<sup>14</sup> In the sense of the distinction drawn here, Rawls' argument on "agreement behind the veil" and justice in the choice of rules and his argument on the "difference principle" are of a systematically different nature. The first concerns the working properties of a specified procedure for choosing rules, the second is a speculation about what rules persons might agree upon.

<sup>15</sup> By "constitutional interests" I mean the preferences of persons concerning the rules under which they would like to live and which they wish to be adopted in their respective groups-communities. Constitutional interests are to be distinguished from "action interests" in the sense that a constitutional interest in seeing a rule adopted in one's community does not per se generate an action interest in complying with the rule. – For a more detailed discussion of this issue see Vanberg and Buchanan, "Rational choice and moral order," in Vanberg (1994a: 60ff.).

<sup>16</sup> By "constitutional knowledge" I mean knowledge about how alternative rules work out in practice, i.e. what kinds of outcome patterns they are likely to produce and how these affect the wellbeing of the persons involved. Buchanan and Tullock as well as Rawls assume in their respective "veil-arguments" that the contracting agents are perfectly knowledgeable in this regard. – On this issue see Vanberg and Buchanan, "Interests and theories in constitutional choice," in Vanberg (1994a: 167ff.).

<sup>17</sup> For a more detailed discussion see Vanberg and Buchanan, "Constitutional Choice, rational ignorance and the limits of reason," in Vanberg (1994a: 178ff.).

study of the allocation of scarce resources among alternative uses became widely accepted as the standard definition of what economics is all about (Buchanan 1990: 30). Notwithstanding its central role in the discipline, the notion that economics is about the utility-maximizing allocation of scarce resources is, so Buchanan argues, fundamentally misleading when it is transferred from the study of *individual* human action to the level of social aggregates and the economy as a whole.<sup>18</sup> And the fact that it invites such transfer makes the maximization paradigm,<sup>19</sup> as Buchanan charges, the source of ambiguity. In particular in welfare economics he identifies, in this regard, fundamental “methodological confusion” (Buchanan 1979, 150ff.).

There exists, in Buchanan’s assessment, a fundamental inconsistency between the methodological individualism that is the classic trademark of the economic approach to social phenomena and the whole concept of a social welfare function, as the standard against which the performance of an economy is to be measured and that is to guide governments in their efforts to correct failures of markets to produce the maximum possible value-aggregate.<sup>20</sup> As Buchanan argues, a tacit methodological shift occurs from the individualist perspective that economists apply when they explain the working of markets in terms of the interplay of individual self-interested actions to the collectivist perspective that they implicitly adopt as welfare-economists when they look at “society” as if it were a quasi-individual that evaluates policy alternatives in terms of its own collective “utility-function.” The systematic reason for this methodological shift lies, in Buchanan’s diagnosis, in an inappropriate generalization of the notion of “rational choice” from the level of individual human action to the level of collective organization. In transferring his familiar concept of rationality as maximizing choice from the level of individual action to the level of collective-political action the welfare economist, so Buchanan charges, treats society as if it were a choosing entity, like an

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<sup>18</sup> Buchanan (1991: 32): “The solution to the exchange process, simple or complex, is not the solution of a maximization problem, and to model it as such is the continuing source of major intellectual confusion in the whole discipline.”

<sup>19</sup> Referring to the Robbins-definition Buchanan (1979: 22f.) notes: “The definition of our subject makes it all too easy to slip across the bridge between personal or individual units of decision and ‘social’ aggregates.”

<sup>20</sup> In the same sense as Buchanan, and with similar arguments, F.A. Hayek has criticized Robbins’ definition as “somewhat misleading” (Hayek 1978: 90, fn. 21), suggesting that economics be defined as “catallactics,” the science of exchange, rather than the science of optimal resource allocation. – As Hayek (1973: 173) notes: “In this respect the aim of what is called ‘welfare economics’ is fundamentally mistaken, not only because no meaningful sum can be formed of the satisfaction provided for different people, but because its basic idea of a maximum of need-fulfilment (or a maximum social product) is appropriate only to an economy proper (i.e. an ‘oeconomia,’ a household-economy, V.V.) which serves a single hierarchy of ends, but not to the spontaneous order of a catallaxy which has no common concrete ends.”

individual, with its own value scale, thereby abandoning the individualism of the classic economic paradigm (Buchanan 1977: 235; 1979: 203f.).<sup>21</sup>

The implicit collectivism of utilitarian welfare economics is not immediately apparent because the “welfare function” with which it operates uses as entries the utilities of the individual members of society and might, in this sense, seem to be “individualist” too.<sup>22</sup> The critical point, though, is that in the utilitarian construction individual human agents count only as the “observation points,” so to speak, from which the welfare economist “reads” the utility-inputs into his calculation of “social optimal” policies.<sup>23</sup> By contrast, the contractarian approach of constitutional economics looks at individuals as the *sovereigns* who are to choose, collectively, among alternative policy options, based on their own judgement of the relative merits of these options.<sup>24</sup> The difference between the pseudo-individualism of the utilitarian construction – I propose to call it *utility-individualism* – and the genuine individualism of constitutional economics – I propose to call it *choice-individualism* – is important because the two perspectives imply fundamentally different concepts of *efficiency* and *legitimacy* in social matters, the one emphasizing the maximization of utility-aggregates the other emphasizing voluntary agreement among sovereign individuals, in matters of collective-political choice no less than in private market choice.<sup>25</sup>

Choice-individualism and its view of individuals as sovereigns is, as constitutional economists in the Buchanan tradition argue, the only perspective at collective-political choice that is consistent with the economists’ standard notion of *efficiency* as applied to market exchanges. Upon careful examination the claim that such exchanges are efficient in the sense

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<sup>21</sup> John Rawls (1971: 27) directs a similar critique against utilitarianism, the philosophical precursor of welfare economics, and its concept of social welfare when he argues: “This view of social cooperation is the consequence of extending to society the principle of choice of one man, and then, to make this extension work, conflating all persons into one through the imaginative acts of the impartial sympathetic spectator. Utilitarianism does not take seriously the distinction between persons.”

<sup>22</sup> Buchanan (1960: 80): “The social welfare function of the utilitarians was based, in this way, on components imputable to individuals. But the welfare edifice so constructed was not necessarily coincident with that resulting from the ordinary choice-making process. It was made to appear so because the utilitarians were also individualists and, in one sense, philosophically inconsistent.”

<sup>23</sup> Buchanan (1960: 117): “In other words, even if the value judgements in the function say that individual values are to count, these preferences must be those presumed by the observer rather than those revealed in behavior.”

<sup>24</sup> Buchanan (1960: 87): “A necessary condition for deriving a social welfare function is that all possible social states be ordered *outside* or *external* to the decision-making process itself. What is necessary, in effect, is that the one erecting such a function be able to translate the individual values (which are presumably revealed to him) into social building blocks. If these values consist only of individual orderings of social states (which is all that is required for either political voting or market choice) this step cannot be taken.”

<sup>25</sup> It should be noted that the above critique of “utility-individualism” applies most directly to what is commonly called “act-utilitarianism.” A rule-utilitarianism that concerns itself with the question of “why ought we to agree to having certain sorts of rules” (Downie 1987: 553) would clearly be much closer to the choice-individualism of contractarian constitutional economics.

of providing gains to both sides can be shown to be, ultimately, based on no other evidence than the fact that the parties involved voluntarily agreed to the transaction. And, as Buchanan notes, it is only on the generalization of this choice-individualist perspective, not by adopting the pseudo-individualism of a social welfare function, that the economic approach can be consistently extended from the study of market processes to political processes. From the perspective of choice-individualism neither market nor state are interpreted in terms of whether or to what extent they serve to maximize some aggregate measure of social utility. They are viewed, instead, as different kinds of institutional arenas that may be more or less suitable for allowing individuals to realize mutual gains, be it gains from trade or gains from joint commitment. As will be more fully explained in section 6 below, markets are seen as institutionally secured arenas for voluntary cooperation within which individuals are free to enter into contracts with others that they expect to work to their benefit, and it is only because – or, more precisely, to the extent that – market outcomes are, indeed, the result of *voluntary contracting* that they can be judged “efficient.” In other words, it is only in terms of the *nature of the process* from which they result, namely voluntary agreements among the parties involved, that the economist can infer the “efficiency” of market outcomes, not from any attributes that might be observed in the *outcomes as such*, independently of the way they have come about. The same applies to the outcomes of political processes, as will be discussed in more detail in section 7 below. Their “efficiency” can, from a consistent choice-individualist perspective, likewise be judged only in terms of the nature of the choice processes from which they result, not in terms of attributes that can be observed in outcomes per se. Here, too, the ultimate criterion of “efficiency” of outcomes can be no other than the extent to which the choice processes from which they result can reasonably be said to reflect the voluntary agreement of the parties concerned.<sup>26</sup>

The central argument of contractarian constitutional economics is that the methodologically consistent way of extending the economic approach from the study of markets to the study of politics, and collective arrangements more generally, is in applying the *procedural* logic that is inherent in the economists’ outlook at market exchange to collective-political arrangements, instead of extending the *outcome-oriented* notion of utility-maximization from individual to collective choice. The essential point in Buchanan’s critique of the *maximization-paradigm* is that, with its *outcome-oriented* logic, it shifts “attention

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<sup>26</sup> The central premise of what, by contrast to *utility-individualism*, I call *choice-individualism* is, in Buchanan’s (1991: 227) words, “that individuals are the ultimate *sovereigns* in matters of social organization” and that “the legitimacy of social-organizational structures is to be judged against the voluntary agreement of those who are to live or are living under the arrangements that are judged.”



away from the institutional structure of an economy” (Buchanan 1991: 31). The principal virtue of the *gains-from-trade paradigm* he sees in the fact that, with its *procedural logic*, it alerts us to the role of the institutional framework within which individuals choose, whether individually and separately in markets, or collectively in politics and in organizational arrangements more generally.<sup>27</sup>

## **6. Welfare Economics and Constitutional Economics:**

### **Alternative Outlooks at Economic Policy**

It should be obvious that a welfare economics that is based on the maximization paradigm and a constitutional economics that is based on the gains-from-trade paradigm must arrive at fundamentally different outlooks at economic policy. As applied sciences both, welfare economics and constitutional economics, seek to use theoretical knowledge that economics can provide to advise politics about possibilities for socio-economic improvement. But their respective views on the kind of knowledge that economics *can* provide and their views on what politics *can* do to achieve improvement are categorically different. Welfare economics claims to be able to measure “improvement” *directly* in terms of the welfare attributes of *outcomes*. Accordingly, it seeks to provide advise for how economic policy can *directly improve outcomes* by suitable interventions into the economic process. By contrast, constitutional economics takes an *indirect* approach to measuring improvement as well as in its views on what politics can do to achieve improvement. Constitutional economics rejects the welfare economists’ claim that as observing analysts we can, in an objective sense, assess the “efficiency” of outcomes per se. Respecting individuals as sovereigns it insists, instead, that inter-subjectively testable conjectures can only be made about the “efficiency” of the *processes* from which outcomes emerge, namely about their suitability for enabling agents to realize mutual gains from voluntary cooperation, “gains” in terms of their own, subjective assessment. Accordingly, constitutional economics sees the principal role that economic policy can play not in seeking to improve outcomes by direct interventions, but in seeking to improve the nature of the processes from which outcomes result, where “improvement”

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<sup>27</sup> Buchanan (1977: 234): “The economist’s task is simply that of repeating in various ways the admonition, ‘there exist mutual gains from trade,’ emphasizing the word *mutual* and forever keeping in mind that ‘trade’ need not be confined to the exchange of goods and services in the marketplace. Welfare economics can make real progress through such a change in approach, which, quite literally, may be called the introduction of ‘constructive institutionalism’.”

means to better enable the individuals involved to advance their own purposes, separately and collectively.<sup>28</sup>

The process-oriented perspective of constitutional economics implies what the German ordoliberals of the Freiburg School<sup>29</sup> have called *Ordnungspolitik*, namely an economic policy that abstains from intervening into the economic process and confines its ambition to “improve the economy” to reforms in the framework of rules and institutions within which economic activities are carried out. From the perspective of constitutional economics there are two principal arguments that speak against discretionary interventions, or, more precisely, two reasons why citizens are well advised to prefer a rule-focused *Ordnungspolitik* over an interventionist, outcome-focused economic policy. This is, first, Hayek’s argument on the limits of knowledge and, second, the public choice argument on the issue of “rent-seeking.”

In Hayek’s diagnosis the ambition to bring about “good outcomes” through discretionary interventions, by “altering a particular action of the system” (Hayek 1976: 129), reflects an attitude that he terms “constructivist rationalism,” an attitude that is based on a “pretence of knowledge,” on the illusion that the policy makers – or their economic advisors – are able to accurately predict and assess the overall welfare effects of specific policy measures. As Hayek charges, given the complex interdependencies in socio-economic systems this means to claim to know more than we can possibly know.<sup>30</sup> It is the “recognition of the proper limits of rational control” (Hayek 1967: 93) that requires us, so Hayek argues, to acknowledge that “it is not in our power to build a desirable society by simply putting together the particular elements that by themselves appear desirable” (Hayek 1973: 56) and, instead, to focus our ambition on the *indirect* strategy “of constructing a suitable legal framework” (Hayek 1948: 22). Such indirect strategy for building a “better society,” not by discretionary interventions but by changing the rules on which the system operates (Hayek 1976: 129; 1992: 185), means to provide for general conditions that better enable the individuals involved to pursue their own purposes, individually and collectively, in terms of

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<sup>28</sup> Buchanan (1991: 20): “The appropriate domain for political economy, for politically directed reform as well as for discussion and analysis of that reform, is exclusively limited to structure. Efforts directed toward effectuating modifications of results that emerge only from complex interdependencies within structures are misguided.”

<sup>29</sup> See fn. 2 above.

<sup>30</sup> One prominent target of Hayek’s charge of “pretence of knowledge” is J.M. Keynes (see e.g. Hayek 1978: 289) about whom A. Carabelli and N. De Vecchi (2001: 280, 283) note: “According to Keynes, the individual agent has to consider each case on its own merits and using his own personal judgement independently of traditional judgements and conventions. ... In *The General Theory*, Keynes defended discretionary intervention, since he showed that public institutions hold partial reasonable knowledge.”

their own evaluations of things and using their own specific knowledge of relevant circumstances.

To be sure, an *Ordnungspolitik* that aims at “constructing a suitable legal framework” faces a knowledge-problem as well, yet there is a critical difference between an economic policy that requires knowledge of all relevant welfare effects of specific interventions and an economic policy that requires knowledge of the general working properties of alternative rules. Knowledge of the latter kind can be gained and systematically improved in a cumulative, experience-guided process of trial-and-error learning.<sup>31</sup> By contrast, an interventionist economic policy that considers “each case on its own merits” cannot equally benefit from such cumulative learning since its major knowledge-problem is that of identifying the relevant particular circumstances and the specific contingencies in ever-new, unique situations.

Constitutional economics advocates a rule-constrained and rule-oriented policy not only because of the knowledge argument that Hayek emphasizes, but also because a discretionary interventionist government is much more vulnerable to rent-seeking than a government that is constrained in its choices by general rules and that is limited in its social and economic policies to reforming the rules under which the system operates. Since rent-seeking means that interest groups seek to induce governments to grant privileged treatment to them at the expense of others, a democratic polity must fail to operate as “a cooperative enterprise for mutual advantage” to the extent that it is susceptible to rent-seeking. And even though a government committed to politics by rules or *Ordnungspolitik* will surely not be immune to rent-seeking, it is much more restricted in its ability to grant privileges than a government that is authorized to intervene in the economic process in a discretionary manner, without committing itself “to do the same in all instances where some circumstances defined by a rule are the same” (Hayek 1976: 129).

## **7. The Constitution of Markets and the Principle of Consumer Sovereignty**

With its rule-oriented perspective constitutional economics takes a quite different outlook at markets than neoclassical welfare economics. Taking the concept of perfect competition as its analytical reference point and looking at markets from the perspective of the maximization paradigm, the neoclassical approach tends to measure the performance of real world markets

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<sup>31</sup> On the relation between Hayek’s concept of cultural evolution, as a process of implicit learning, and the notion of deliberate constitutional design see Vanberg 1994b.

against the maximization standard, and where it finds reality to fall short of the ideal standard, it diagnoses a need for political correction of “market failure.”

By contrast, looking at the market as a “social institution which facilitates exchange” (Coase 1988: 8), constitutional economics starts from the recognition that markets are legal-institutional arrangements and that all we can meaningfully compare – and choose among – are alternative, actual or potential legal-institutional frameworks. This is what Hayek (1976: 115) points to when he argues that the operation of the market system and the way it coordinates the actions of market-participants can be understood best by thinking of it as a game, “the game of catallaxy.” The game metaphor is meant to emphasize two essential attributes of the competitive market process. First, it “proceeds, like all games, according to rules guiding the actions of individual participants” (ibid.: 71). And, second, as with all genuine games, the particular outcomes of the “game of catallaxy” that result from the complex interaction of the “players” remain necessarily to a large extent unpredictable, due to the multitude of contributing factors and to the inventiveness of the participants who choose their strategies within the constraints defined by the general rules of the game.

By speaking of the market as a “game” that is played according to certain rules, Hayek underscores the inherent connection between the working properties of market processes and the nature of the legal-institutional framework within which they operate. As he (Hayek 1960: 229) puts it: “How well the market will function depends on the character of the particular rules. The decision to rely on voluntary contracts as the main instrument for organizing the relations between individuals does not determine what the specific content of the law of contract ought to be; and the recognition of the right of private property does not determine what exactly should be the content of this right in order that the market mechanism will work as effectively and beneficially as possible.” – It has been the core tenet of the ordoliberal Freiburg School, and it is the central theme of constitutional economics, that the principal task of economic policy in improving markets is to provide for a “suitable” legal-institutional framework,<sup>32</sup> and that the principal practical contribution that economics can make is to assist such efforts. And “suitable” can in this context mean nothing other than serving the common constitutional interests of the persons involved.

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<sup>32</sup> The ordoliberals of the Freiburg School stressed that a well-functioning market is not self-generating but requires deliberate political efforts to create and maintain a conducive “economic constitution.” - L. Robbins (1952: 56) expresses a view quite similar to that of the ordoliberals when he notes: “So far from the system of economic freedom being something which will certainly come into being when things are just left to take their course, it will only come into being if things are not left to take their course; if a conscious effort is made to create the highly artificial environment which is necessary if it is to function properly.”

As noted before, from the process-oriented perspective of constitutional economics, what “improving markets” means cannot be measured in terms of attributes of market-outcomes per se. It must be measured in terms of attributes of the processes that unfold under alternative legal-institutional frameworks, namely the extent to which they enable agents to realize mutual gains from voluntary cooperation. The term *consumer sovereignty*<sup>33</sup> has often been used in the classical liberal tradition to describe the criterion against which the performance of markets is to be measured. The ordoliberalists of the Freiburg School had essentially the same performance-criterion in mind when they adopted the term *Leistungswettbewerb* (performance-competition) in order to emphasize that the “rules of the game” of the market should, ideally, be defined and enforced in a manner such that better service to consumers is the only route to business success (Vanberg 1998a).

The process-oriented concept of consumer sovereignty, i.e. the notion that consumer choices should be the essential controlling force in economic processes, was implied in Adam Smith’s (1981: 660f.) concept of the “simple system of natural liberty.”<sup>34</sup> It is not meant to be descriptive of any “market” that we may observe, but denotes an ideal standard against which the institutional-legal frameworks of existing markets can be judged.<sup>35</sup> For Adam Smith this was a self-evident ideal because, so he argued, we produce in order to consume and should, therefore, assign priority to consumer interests over producer interests in choosing the rules of the economic game (Smith 1981: 660). More explicit reasons to support this claim may well be necessary, though, to convince persons who find themselves on both sides of the interest-divide. People are typically involved in the economic nexus not only as consumers but as producers (as investors, as employees etc.) as well, and it may be anything but perfectly obvious to them why they should prefer an economic constitution that makes their interests as producers subservient to consumer interests.<sup>36</sup>

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<sup>33</sup> The term seems to have been coined by William H. Hutt (1943: 215).

<sup>34</sup> Smith’s formula of the “simple system of natural liberty” was, of course, not meant to say that well-functioning markets are a “natural” phenomenon. As N. Rosenberg notes, in Smith’s view a particular institutional framework was required for the beneficial working of markets, a framework that would “cut off all avenues (and there are many) along which wealth may be pursued without contributing to the welfare of society” (Rosenberg 1960: 560).

<sup>35</sup> Depending on the nature of the institutional framework, consumer sovereignty can, as Hutt notes, be realized in different degrees: “According to the nature of the economic institutions tolerated or created by the State, so we may regard consumers’ sovereignty as receiving complete or incomplete expression; and it is under competitive institutions that we find its full and untrammelled realization” (Hutt 1990: 261).

<sup>36</sup> Hutt (1990: 257f.): “In regarding the individual as a consumer, we do not see him in his full relationship to society. He is usually also a producer. But as a producer he is the servant of the community. ... As a ‘consumer’, each directs. As a ‘producer’, each obeys.” – In reference to Hutt’s argument Buchanan (1991: 121) notes: “The appeal to consumers’ sovereignty (carefully qualified and interpreted) is perhaps persuasive to economists, but there is no easy response to someone who asks: Why consumers?”

As explained above, from a contractarian constitutionalist perspective whether a constitution qualifies as “desirable” is to be judged in terms of the *common constitutional interests* of the agents involved, i.e. in terms of whether or not it can be shown to work in a manner mutually beneficial for all parties. Accordingly, the claim that they are better off with an economic constitution that gives priority to their interests as consumers over their interests as producers translates into the claim that such an economic constitution is in their mutual or common constitutional interest. Obviously, this claim can be controversial only insofar as consumer interests and producer interests come into conflict. If we agree that consumer interests are best served by a constitution that assures *consumer sovereignty* or *Leistungswettbewerb* we must conclude that conflicts between consumer interests and producer interests can arise only where producers would prefer to escape the constraints of a competition in which consumers are the ultimate judges about success and failure. Interests in being protected or shielded from the constraints of such competition - and this means, in particular, interests in government-granted protectionist regulations<sup>37</sup> - can, however, be shown to be typically interests in *privileges*, i.e. in provisions that grant privileged treatment to particular groups of producers, as opposed to rules or regulations that apply equally and indiscriminately to all agents in the economy (Vanberg 2001). Demands for protection (import restraints, entry barriers, subsidies etc., etc.) are always raised for, and on behalf of, particular groups of producers or industries, never for *all* producers in the respective jurisdiction. Producers in industry A, for instance, seek protection from their own foreign competitors, they do not demand that producers in other industries, including those from whom they purchase inputs, are likewise protected. In fact, if the protectionist regulations were extended indiscriminately to all producers they would no longer be in anybody’s interest, as the net-balance of benefits to one’s own industry and of the harm that results from the protection of other industries is bound to be negative. In other words, producer interests in protectionist regulations are always interests in privileges, they do not reflect common constitutional interests shared by all producers, let alone by the citizenry at large. The benefits that protectionist regulations provide are unilateral benefits that favor particular groups at the expense of others, by contrast to the mutual benefits that accrue from rules that are in the common constitutional interests of all participants.

It is because of its overall beneficial working properties that people have good reasons to prefer an economic constitution of *Leistungswettbewerb*, notwithstanding the protectionist

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<sup>37</sup> In order to focus attention on the more relevant issue I disregard here the fact that protection from competitive constraints can, of course, be sought also by private arrangements (cartels, monopoly).

interests that they may hold in their capacity as producers. Their protectionist interests as producers can be served only by rules that grant protection as a *privilege*, not by non-discriminating, general rules that equally apply to everybody in the respective jurisdiction. Protectionist constitutions are, inevitably, either discriminating constitutions that benefit some at the expense of others or, were they are not discriminating, that are detrimental to all.

The fact that only an economic constitution of *Leistungswettbewerb* is in people's *common constitutional interest* does not mean, though, that it would be an easy task to implement and to maintain such a constitution politically. Even though such a constitution can be shown to be mutually beneficial to all involved, incentives remain for interest groups to seek for themselves the extra benefits of special privilege while taking advantage of an otherwise competitive economy. The problems that such incentives create for the political process by which the rules of the game are chosen have been extensively discussed in the literature, by the ordoliberals of the Freiburg School, who referred to them as problems of *privilege-seeking* (Vanberg 1998a), no less than by modern public choice theorists who have addressed the issue under the rubric of *rent-seeking* (Buchanan et al., eds, 1980).

The mutual benefits that agents can expect from an economic constitution that aims at *consumer sovereignty* result from, and depend on, their willingness jointly to submit to the constraints of *Leistungswettbewerb*. To accept the burden that such constraints impose on them in their capacity as producers is a price worth paying if that is the precondition on which the others are willing to act likewise. But it is a price that agents will seek to avoid paying if they can have it both ways, to secure protectionist privileges for themselves and to enjoy the benefits of an otherwise competitive order. If people's common constitutional interests are to be protected from erosion by privilege-seeking, effective institutional precautions will be needed that eliminate, as far as possible, the option of having it both ways.

## **8. The Constitution of Politics and the Principle of Citizen Sovereignty**

Democracy is usually defined in terms of specific institutional characteristics, most commonly as a system of government that is based on majority rule. Constitutional economics, by contrast, does not take an institutional feature like majority rule as the fundamental attribute of democracy but considers it more adequate to start from a more generic notion. It looks at democratic polities, in John Rawls' (1971: 84) terms, as "cooperative ventures for mutual advantage," i.e. as collective arrangements that are supposed to advance common interests of their members. Just as private *cooperative* or *member-owned* enterprises are there to promote common interests of their members, democratic polities, as

“*citizens cooperatives*,” are there to serve the interests of their constituents, the citizens. And just as the organizational rules of ordinary cooperatives can be judged in terms of their capacity to promote the common interests of their respective members, the rules and institutions of democratic politics can be seen as organizational devices that may help citizens-members-constituents to realize mutual benefits. Instead of taking a particular institutional feature, such as majority rule, as the defining characteristic of democracy, constitutional economics insists that the issue of what institutional rules and procedures are most appropriate for democratic polities as *citizens cooperatives* ought to be regarded as a *factual* matter. In other words, constitutional economics suggests that potential alternative rules and institutions of democratic politics ought to be analyzed, and compared to each other, with regard to their capacity to enable citizens to realize mutual gains, - and to protect them from being exploited, through the political process, by fellow-citizens or by political agents.

The criterion for desirability or “efficiency” implied in the understanding of democratic institutions explained above may be called *citizen sovereignty*, in analogy to *consumer sovereignty*. *Citizen sovereignty* means that the individuals who constitute the citizenry of a democratic polity are the ultimate sovereigns in whose common interests the polity should be operated and that, accordingly, the political process should be institutionally framed in a manner that makes citizens’ common interests its principal controlling force.<sup>38</sup> In other words, citizen sovereignty requires that the “producers of politics,” politicians and government bureaucrats, are made most responsive to citizens’ common interests. Like consumer sovereignty, citizen sovereignty is a *procedural* criterion. It cannot be applied to outcomes directly, but only to the processes from which outcomes result. It requires that the institutions and decision-making procedures of democratic polities are designed so as to maximize the prospects that the political process works to the mutual advantage of all citizens.

It is in the above sense that Buchanan speaks of his own approach to politics as a “voluntary exchange theory of politics,” as a theory that looks at politics as an arena where

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<sup>38</sup> Even though I discuss them in parallel, it should be noted that consumer sovereignty and citizen sovereignty do not have quite the same status as normative criteria. Instead, the latter must be acknowledged to take precedence over the former in the following sense. In its application to democratic polities as citizens cooperatives the principle of normative individualism directly implies the criterion of citizen sovereignty. By contrast, the criterion of consumer sovereignty is not a direct implication of the principle normative individualism. Whether consumer sovereignty is adopted as normative criterion for measuring the “efficiency” of markets must be treated as a matter of prudence rather than a matter of principle. If the constituents of a democratic polity would voluntarily choose to adopt an economic constitution based on a different performance-criterion, this may be considered imprudent by outside observers, but it could not be said to be in conflict with the principle of normative individualism. The principle of normative individualism requires that the individuals involved are respected as ultimate sovereigns in their constitutional choices (citizen sovereignty), it does not pre-determine the content of the constitution under which people may wish to live.



mutual gains from cooperation can be realized (Brennan and Buchanan 1985: 25ff.; Buchanan and Congleton 1998: 16ff.). In analogy to the market as an arena where agents can realize mutual gains by means of private voluntary contracts, politics is seen as the arena where agents can realize mutual gains by means of political organization. Such voluntary exchange theory of politics is not meant, of course, as the factual (and quite obviously false) claim that all polities that we observe and that have been recorded in history can meaningfully be classified as voluntary arrangements. Instead, it is meant to say that the notion of voluntary cooperation for mutual advantage can, from the perspective of normative individualism, be used as the measuring rod against which existing political arrangements can be judged. It implies the claim that in politics, no less than in markets, there can be no other ultimate test of mutual advantage than voluntary agreement.<sup>39</sup>

The principle of *citizen sovereignty*, i.e. the ideal that democratic polities serve the *common interests* of their citizens and derive their legitimacy from voluntary agreement, may seem illusionary in light of the realities of majoritarian democracy. The existing institutions of democratic politics are clearly not designed to allow only for policies that benefit all citizens and that could, therefore, secure unanimous voluntary agreement. Instead, political decisions are regularly passed without unanimous approval, by majority vote, and those in disagreement are forced to accept whatever the majority decides. Indeed, it is difficult to see how democratic politics could be workable if it were restricted to choices voluntarily agreed to by all participants. - If this has to be acknowledged, how can the criterion of mutual advantage and voluntary agreement be meaningfully applied at all to the realm of politics?

The contradiction that may seem to exist between the demands of the ideal of citizen sovereignty and the realities of democratic politics can be resolved, though, if we carefully distinguish between voluntary agreement as the ultimate *legitimizing principle* for political action and unanimity as a *decision rule* in practical politics. The principal argument on this matter has been stated by J.M. Buchanan and G. Tullock in their classic contribution to public choice theory, *The Calculus of Consent* (1962). Voluntary agreement as the ultimate legitimizing principle reflects the normative standard, rooted in normative individualism, that a democratic polity operate as a “cooperative venture for mutual advantage,” and it accounts for the fact that there can, ultimately, be no other test of “mutual advantage” than the agreement of the parties involved. Yet, as Buchanan and Tullock have pointed out, while normative individualism requires us to acknowledge voluntary agreement as the ultimate

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<sup>39</sup> In one referee’s comments on this paper the “voluntary exchange theory of politics” is charged with an inherent bias toward preserving the status quo. Addressing this issue adequately would go beyond the scope of this paper. I have discussed this issue however in some detail in Vanberg 2004.

legitimizing principle it does not require that unanimity be applied as decision rule in democratic polities. The reason is that there are significant disadvantages or costs of using unanimity as a *decision rule* for the day-to-day operation of the polity as a “cooperative venture,” due to problems of strategic behavior and for other reasons. The practical disadvantages of using unanimity as decision rule in everyday politics provide prudential reasons for members of a democratic polity to voluntarily agree to adopt less-than-unanimity rules for deciding ordinary policy issues. It is their voluntary agreement at the *constitutional* level that legitimizes the application of non-unanimous choice procedures at the sub-constitutional level.<sup>40</sup> In other words, majority rule is not a self-legitimizing principle, nor is it a generic attribute of democracy. It is a “derived” or “secondary” institutional feature that citizens-members of democratic polities adopt for prudential reasons, and it is indirectly legitimized by the citizens’ voluntary agreement to be subject to majority decisions in day-to-day politics.

The transition from unanimity to majority decisions implies, of course, the possibility that political decisions will be made that are *de facto* not to everybody’s benefit and that do not find the voluntary agreement of all members of the polity. This does not mean, however, that the ultimate normative standard – mutual advantage and voluntary agreement – loses its relevance as legitimizing principle in the face of democratic reality, and that we need to look for some other criterion of legitimacy. It simply means that, given the inevitable facts of organized political action, adopting decision-making rules that allow for non-unanimous decisions may provide overall the best prospects for citizens to advance their common interests. What makes the institutions of democratic politics agreeable is, in this sense, not that the outcomes they produce are always to everybody’s benefit, but the fact that – among feasible alternative institutional arrangements (including one that operates entirely on unanimity rule) – they offer overall the best balance between the promises and the risks of political organization.

From a contractarian constitutionalist perspective there is – figuratively speaking – an unlimited “ocean” of potential mutual benefits “out there” that constituencies of polities at various levels, from local communities to world-wide arrangements, may discover and capture, just as there is an unlimited ocean of potential gains from trade “out there” that agents in markets may discover and exploit. That such potential gains are “out there” does, of

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<sup>40</sup> If, as we have to assume, an institutional arrangement that would require *unanimity as decision-rule* for all in-period choices is less attractive to citizens in its overall working properties than one that allows for non-unanimous choices, it has to be judged inferior in terms of the underlying criterion, i.e. *unanimity as a legitimizing principle*. It is the application of the criterion of mutual advantage and voluntary agreement at the *constitutional level* that carries overriding power here.

course, not assure that they will in fact be discovered and realized. Free-riding, strategic bargaining, shortsightedness and simple ignorance are important obstacles. Depending on the suitability of their respective institutional-constitutional design, markets as well as democratic polities may be more or less successful in enabling the respective agents to actually capture mutual gains, i.e. their performance may be more or less in accordance with the criteria of consumer sovereignty and citizen sovereignty. As applied science, constitutional economics seeks to provide advice for how to “improve” the institutions of markets and politics in the sense of enhancing consumer sovereignty and citizen sovereignty.

### **9. Constitutional Commitment: Original Versus Continuing Agreement**

As joint commitments to rules constitutions define the terms of an *ongoing* cooperative enterprise. They define the rules of the game that the participants in a joint enterprise accept as binding for their future dealings with each other. The contracting parties voluntarily agree at the constitutional level to be subject to binding constraints at the sub-constitutional level. Accordingly, as noted above, the burden of providing legitimacy to the day-to-day operation of democratic polities lies ultimately with the voluntary agreement of all members to the constitution that defines the rules of the game of ordinary politics. This is often interpreted, at least implicitly, as if the *original* agreement to the constitution were all that matters. Such interpretation is suggested, in particular, by arguments that employ the notion of an *original contract* behind a veil of ignorance or uncertainty in order to provide plausibility to the idea that constitutional contracts may gain unanimous approval. Though the conceptual construct of constitutional choice behind a “veil” is useful for some purposes, it can easily be misleading because by focusing attention to the issue of *original* agreement; it distracts from the much more important role of *ongoing* agreement.

A comparison between democratic polities and ordinary clubs as “private cooperative enterprises” is useful to illustrate the issue. Ordinary voluntary clubs may look back on a recorded history that can be traced to their very origin in a voluntary contract signed by their founding members. Yet, whether or not this is the case is largely irrelevant in judging the legitimacy of a club’s *current* operation. What is of relevance, instead, is the *ongoing* voluntary acceptance of the club’s constitution by its *current* members. To the extent that its current members have joined the club voluntarily and keep up their membership by voluntary choice, the club can justly be considered legitimized as a cooperative enterprise to the mutual benefit of its members, no matter what its founding history may have been.

The same argument applies to democratic polities. It is the *ongoing* voluntary agreement of its members-citizens that provides legitimacy to the constitution of a democratic polity, not some original agreement that may or may not have existed at the founding of the polity. A constitutional arrangement may have enjoyed voluntary agreement at its origin, if an “original contract” can be meaningfully identified at all. Yet, if it is no longer generally accepted by its current members it can surely not be considered more legitimate than a constitutional arrangement that may have been imposed originally by outside force or by decree, but that in its current operation is met by general approval within the respective constituency.

The essential burden of providing legitimacy to the operation of democratic polities lies with the *ongoing* voluntary agreement of their members-citizens to the respective constitutional framework. While the proximate test of such agreement is in citizens’ voiced approval or disapproval, in elections or otherwise, its *ultimate* test must be seen in citizens’ voluntary choice to remain within the jurisdiction in the presence of accessible alternative options (Hirschman 1981). This means that efforts at assuring that democratic polities function to the mutual benefit of their constituents should not only concentrate on making the internal democratic procedures to conform to the ideal of citizen sovereignty, but should also aim at facilitating voluntary choice among alternative jurisdictions by making alternatives more easily accessible.<sup>41</sup> This is the principal reason why institutional provisions that fall under the rubric of *competitive federalism* are important devices for improving the performance of democratic polities.

The issue of competitive federalism concerns another major implication of the contractarian constitutionalist perspective that deserves to be mentioned. This is the fact that gains from joint commitment may be realized at various levels of political organization. The dominating role that nation states have acquired over the past two or three centuries has resulted in a concentration of all kinds of governmental activities at this particular level of political organization. It is, however, extremely unlikely that the evolved concentration of political responsibilities at the level of the nation state is best suited to the diversity of citizens’ common interests. It is much more likely that some of these responsibilities can be more efficiently accounted for at various supra-national levels, and that others may be much better provided for at various sub-national levels of political organization. In fact, the familiar

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<sup>41</sup> Friedman (1962: 3): “If government is to exercise power, better in the county than in the state, better in the state than in Washington. If I do not like what my local community does, be it in sewage disposal, or zoning, or schools, I can move to another local community, and though few may take this step, the mere possibility acts as a check. If I do not like what my state does, I can move to another. If I do not like what Washington imposes, I have few alternatives in this world of jealous nations.”

distinction between the levels of local communities, states or provinces, nations and supra-national arrangements reflects, in this regard, only a subset of the potential diversity of constituencies with common interests.

The ideal that democratic polities function as cooperative ventures for mutual advantage requires that there should be, to the largest extent possible, a congruence between the allocation of political authority and the geography of common interests. A political world organized in such manner would be a world in which individuals are members – either directly as individuals or indirectly, in their capacity as citizens of lower-level polities – of a multitude of political units at various levels and with different domains of authority, some of them limited in their authority to rather narrow functions. What is needed to bring such congruence about is a flexible mechanism that can adjust the allocation of political authority to changing circumstances and technological opportunities in ways that are responsive to the many varieties of citizens’ common interests. Institutional provisions that can be broadly subsumed under the rubric of competitive federalism can serve a useful function in bringing the structure of political authority in line with the geography of common interests.

## **10. Conclusion**

The central question around which the research program of constitutional political economy revolves is: How can social arrangements and the process of societal change be framed or “channeled” by rules so that the individuals involved are enabled, to the largest extent possible, to successfully pursue, in mutually compatible ways, their individual and separate as well as their common interests. From this perspective, market and state are looked at as different kinds of arenas in which people may realize mutual gains from voluntary cooperation. The working properties of these arenas depend on their respective *constitutions*, i.e. the rules of the game that define the constraints under which individuals are allowed, in either arena, to pursue their own interests. Improving the legal-institutional frameworks of markets and of politics, so as to enhance the prospects for mutually beneficial transactions and joint projects to be realized, is the principal means by which people can seek to bring about a better socio-economic-political world. As I have sought to show, for markets this means to adopt and to maintain an economic constitution that enhances *consumer sovereignty*, and for the political arena it means to adopt and to maintain constitutional rules that enhance *citizen sovereignty*.

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