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ECONOMIC POLICY
BY CONSTITUTIONAL CONTRACT



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I. PUBLIC CHOICE AND ECONOMIC POLICY

Empirical research and analysis done in Public Choice¹ have shown that all political decision-makers pursue their own self-interest while responding to various sets of incentives and acting within an interdependent politico-economic system of which the government is an endogenous part. So far, however, there has been very little research done on what this means for the formation and implementation of the theory of economic policy. The basic problem is simply stated: what types of economic policies can be undertaken when government is an endogenous element of a system of such interdependencies?

This paper is concerned with what has become the major approach to the theory of economic policy in the context of political economy, the idea of the constitutional contract. This is a major development that may even lead to a new definition of economics as being more a science of contract than a science of choice, as ROBBINS has described it². The paper describes the idea of constitutional contract (*Section II*),

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1. GOTTFRIED BOMBACH, at first somewhat skeptical about Public Choice, has become a strong though critical supporter; see for example his application of it to problems of income distribution [1972] and his recent survey of the field [1977]. For other surveys of Public Choice see MUELLER [1976] and FREY [1978b].

2. This development is mainly due to BUCHANAN [1975, 1977], with the basic ideas already having been spelled out in his and TULLOCK's classic work [1962]. For a discussion of the general revival of contractarian thinking also in philosophy, see the critical survey by GORDON [1976].

and discusses some areas of application (*Section III*) and the possibilities and problems connected with it as an approach to economic policy (*Section IV*). The concluding section (*V*) evaluates the import of constitutional contracts for the future development of economics. Though we have limited ourselves to a discussion of constitutional contracts, there are of course other possibilities that can be used for carrying out economic policy in a democratic politico-economic system³, such as the dissemination of information at the post-constitutional level (which enables the decision-makers to better choose and achieve their goals, thus indirectly furthering the common good via the hidden hand).

II. CONSTITUTIONAL CONTRACT

1. *The Basic Idea*

Fundamental aspects of the social order can in a modern and democratic society only be regulated through consensus and voluntary cooperation. Only if all the individuals and groups cooperate can decisions on the fundamental questions of society be made and carried out. In such an idealized world no one would be coerced into abiding by decisions taken by the majority because all individuals and groups would be able to exercise a veto power through formal or informal decision rules, and through other forms of political process. If the ground rules are arranged without the consent of all the individuals and groups, the political system may end up being destroyed through either internal struggle or by the non-consenters exiting.

A constitutional contract meets the following conditions:

- (a) It applies to fundamental and long-range decisions;
- (b) It is formed in the 'natural state', *i.e.* behind the 'veil of ignorance'. This is in contrast to the post-constitutional stage in which the social and occupational status and therefore the interests of individuals and groups are clearly known;
- (c) It must have the unanimous consent of all individuals and/or groups;

3. They are discussed in FREY [1978a].

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- (d) It is the result of a PARETO-superior improvement which may be due to new information or social innovation.

A constitutional contract need not be written. It may arise spontaneously, or be the result of deliberate activity on the part of the economic policy advisor.

The importance of consensus and voluntary cooperation may be illustrated by two examples.

- Reforms of the public bureaucracy with the goal of increasing its efficiency and responsiveness to the population's preferences are almost always vigorously opposed by the bureaucracy's members. As is the case with other decision-makers, it is also assumed here that bureaucrats act in their own interest; and as reforms of the bureaucratic system tend to threaten their monetary and non-monetary income and discretionary power, it is in their self-interest to reject such proposals. Reforms, however, are only possible if the bureaucrats favor them, or at least do not actively oppose them. They are successful in their opposition because the government needs their cooperation in order to reach its own goals (its re-election, for example), and because many members of the legislative body are also members of the public bureaucracy. A constitutional arrangement must thus be sought that provides a solution to which the present members of the bureaucracy will agree.
- Some sort of incomes policy seems to be unavoidable, if inflation is seen as resulting at least partially from the struggle among groups for their share of the national income. The groups try to further their own individual interests by influencing fiscal and monetary policy and other forms of government activity. Empirical evidence has shown (see *e.g.* BRUNNER/MELTZER [1976]) that groups cannot be *forced* to participate in an incomes policy over an extended period of time. Thus the cooperation of all groups is needed to maintain it, which means that a constitutional contract must be sought.

According to the constitutional contract view, economic policy advising has little if any influence on the workings of the politico-economic system at the post-constitutional stage. It is therefore crucial that the ground rules be carefully worked out at the constitu-

tional level so that the post-constitutional process automatically works well, *i. e.*, responds as much as possible to the population's preferences, thus continuing to retain their agreement.

2. *The Task of the Economic Policy Advisor*

If the contractarian view is accepted, the economic policy advisor is seen as having quite a different task to fulfill as compared to that under the traditional theory of economic policy, in which his/her role is to help a hypothetical benevolent dictator attain the common good. Here, on the other hand, the economic policy advisor's task is to arrange contracts; she/he has to work out compromises among conflicting interests. This involves three major tasks.

- (a) The economic policy advisor must search for new possibilities for Pareto-optimal improvements. Such arrangements potentially benefitting everyone may not have been reached spontaneously previously because of lack of information, high transaction costs, or the strategic behavior of some individuals or groups aimed at blocking such an arrangement. The advisor can also try to find ways to form new social contracts by suggesting social innovations that the participants in the social contract are not aware of.
- (b) The economic policy advisor acts to bring about the formation of social contracts using the various instruments at his/her disposal. She/he may bring about conditions of uncertainty so that the individuals and groups affected are forced to take a broader standpoint rather than making decisions on the basis of their own narrow and short-term interests. The advisor may also work out compensation schemes of various kinds to serve as incentives for joining the contract. This means that the facts of the actually existent situation must be recognized for what they are before changes can be made. Groups that do not want to cooperate for strategic reasons may be induced to participate in the agreement by convincingly showing them that non-cooperation may lead to a worse outcome for them.
- (c) Finally, the economic policy advisor must see to it that the contracts formed at the constitutional stage are kept in the post-constitutional set-up. It is thus important that the proper institutions are introduced to help maintain the contracts established,

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and to prevent majorities and well-organized and vocal minorities breaking the agreements. The economic policy advisor should make sure that only those contracts are closed that have a reasonable chance of being kept. Contracts that are too weak become irrelevant; but if they are too strict, they run the danger of being broken. This means that the economic policy advisor must also propose alternative periods of duration for the social contracts among which the constitutional decision-makers may choose.

III. APPLICATION OF CONSTITUTIONAL CONTRACTS

Unanimous social arrangements potentially benefitting everybody could be worked out for a great many social problems. Three main areas of application can be distinguished.

1. *Determination of Fundamental Political Rules and Institutions*

In order for the post-constitutional process to fulfill the population's wishes, constitutional contracts must be established to guarantee the democratic ground rules of the society. Such contracts are needed:

- (a) to specify the individual's and other political rights, such as freedom of speech, freedom of press, and private property rights;
- (b) to specify the structure of the state. Separation of powers (executive, legislative and judiciary) can be guaranteed; the extent of popular participation in the political process can be fixed (in particular, whether there should be the institutions of the referendum and initiative). The same applies to the extent and form of economic democracy practiced, *i.e.* whether and how much co-determination (*Mitbestimmung*) there is to be in the firm and/or at higher levels of the economy. Finally, the degree of regional decentralization and the extent of federally held powers must be determined.

Such ground rules are already contained in the written constitutions of most democratic countries. This is, however, not so to the same extent in the following two areas of constitutional contract-making.

2. *Determination of the Role and Division of Labor Among Fundamental Socio-Economic Decision-Making Systems*

Public Choice has undertaken a positive analysis of the functioning and failures of a democratic society's four major decision-making systems. Consensus must be reached on the constitutional level about how to overcome these failures and to divide the labor among them.

(a) Market

It is well known that the price system only leads to Pareto-optimal outcomes under very specific and restrictive conditions. Market failures are thus the norm. Practical economic policy has tried various means for improving the market's functioning, including anti-trust policies, regulation, investment guidance (*Investitionslenkung*) and full-scale planning, consumer protection policies, and structural policy (*Strukturpolitik*).

Recent research suggests that these policies as applied in reality have rather negative effects. This is particularly true for structural policy, which has served more to protect inefficient sectors than to help bring about necessary structural changes in the economy; and for regulation, which has tended rather to harm than to help consumers. Empirical research also suggests that the efficiency losses due to the existence of monopolistic firms and sectors are rather small, *i. e.* there is little to be gained by a vigorous anti-trust policy (see *e. g.* POSNER [1975]).

(b) Democracy and Government

The work of ARROW [1951] has convincingly shown that democratic decisions are also subject to failure. Simple majority rule, by far the most popular decision mechanism, has various important disadvantages. For example, the intensity of preferences may not be indicated; the outcome is only by chance Pareto-optimal; and the process is subject to manipulation and strategic voting. It may well be that some of these failures can be overcome by introducing social innovations in the form of new decision rules at the constitutional level (see *e. g.* TIDEMAN/TULLOCK [1976]).

In democracies (as well as, of course, in authoritarian systems), government failure also occurs. It has become one of the most im-

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portant tasks of economics to think about ways to control the government at the post-constitutional level so that it respects the population's preferences. There are various constitutional arrangements possible that can help achieve this goal. Competition among the political parties, for example, can be intensified by making it easier to remove the ruling party from office and by lowering the barriers to entry for new parties. Financial support of new parties by the state should also be seriously considered. It is clear, however, that such support would have to be provided for at the constitutional level because the existing parties would, for obvious reasons, prevent the adoption of such a policy in the post-constitutional stage. Other possibilities for controlling government would be to introduce the institutions of referenda and initiatives, and to inform the voters about the actual costs of government activity. This may be achieved by setting up an independent information agency, simplifying the tax system, and allowing only direct income transfers (and not indirect subsidies via price controls and other means). Such constitutional provisions would have a strong effect on the post-constitutional process.

(c) Public Bureaucracy

Public bureaucracy has an interest in, and therefore exerts pressure towards, increasing government expenditures and public employment. Additionally, bureaucrats tend to act inefficiently because of insufficient monitoring and incentives. These bureaucracy failures are often noted, but it is rarely seen that they can only be overcome by agreement at the constitutional level.

The following constitutional contracts could be suggested by the economic policy advisor: measures can be taken to increase competition among the administrative units and vis à vis the private sector; instruments can be pushed which involve little bureaucratic activity, such as tradeable licenses; ceilings can be imposed on public expenditures and employment; possibilities for direct voter participation can be increased.

(d) Interest Groups

Only some of the economic interests present in the population are organized into effective interest groups, which then may exert strong influence on the political process through both formal and informal

channels. Thus some interests may be overrepresented while others are left unorganized and thus powerless. Again, various measures can be taken at the constitutional level to counteract this interest group failure: interest groups may be forced to publicize their activity more; party competition may be increased, which would act to force each individual party to resist the influence of narrow interest groups more; competition among interest groups may be increased by organizing those latent ones such as consumers and taxpayers.

*3. Determination of Fundamental Rules of Allocation,
Distribution and Stabilization*

Constitutional contracts can play an important role in the classical domains of economics. Some examples will be given to illustrate the flavor of this approach.

(a) Allocation

It may be argued that the public sector's activity must be more strongly controlled in order to guarantee that the population's preferences are fulfilled. As it is unlikely that this can be done at the post-constitutional level, even in representative democracies, it is important that it be done by constitutional agreement.

One possibility that has been suggested (BRENNAN/BUCHANAN [1977]) is to restrict the tax bases that the public sector has available to it for financing its expenditures. If government has only a few bases, or perhaps even only one, such as private income, tax receipts will automatically have an upper bound by virtue of individuals choosing to escape the tax (by reducing their working and increasing their leisure time, for example). This will restrict government expenditures if a constitutional provision first insures that all expenditures are to be financed by taxes only.

This proposal can be contrasted with the orthodox view based on welfare theory. There it is suggested that the tax base should be as comprehensive as possible in order to minimize distortions and welfare losses⁴. The difference between the constitutional view and the

4. See the literature on optimal taxation, e.g. the survey by BRADFORD/ROSEN [1976], and by SANDMO [1976].

orthodox welfare view lies mainly in what is considered to be the main welfare loss: the constitutional contract view does not see it in the efficiency losses that result from distortions brought about by taxes, but rather in the losses due to too large and inefficient government expenditures.

(b) Distribution

The classical motive for closing contracts at the constitutional stage is to secure a different distribution of income than that which would otherwise spontaneously emerge from the post-constitutional process. The arrangement of intergenerational transfers at the constitutional level provides the most important example so far. It is a voluntary contract between generations in which it is agreed, in order to get around the free rider problem, that every individual within a given generation will be forced to participate in an inter-temporal redistribution scheme. It may be time now to reconsider the presently existing contract, as there is a real danger that it cannot be maintained in the future, and that the transfers are, at least for some people, too high: some of the old do not consume the pensions they receive, while the weight placed on the working generation has become very heavy indeed and may end up having serious disincentive effects.

(c) Stabilization

It has already been mentioned that in a modern democratic society groups cannot be *forced* to restrain their wage and price demands. Only a voluntary or cooperative incomes policy will do. This has been clearly understood by politicians, who have coined such names as 'concerted action' and 'social contract'. The participation of all major societal groups is needed for any stabilization policy, irrespective of the specific approach. Even if the supply of money is considered to determine the development of prices, a voluntary agreement among the various groups is needed so that the supply of money can indeed be controlled by whoever is in charge of monetary policy.

An incomes policy is of course confronted with a great many problems (see BOMBACH [1969]), such as the incentive to deviate from it because of the free rider effect; the fact that the maximum wage guidelines are soon taken as setting the minimum wage increases; and possible distortions in the allocation of resources. Past experiences

have indeed been quite discouraging. In order to be maintained at the post-constitutional stage, the gain achieved from the Pareto-optimal improvements resulting from a lower rate of inflation must be distributed in such a way that the groups and individuals involved have an incentive for keeping the contract. It is the task of the economic policy advisor to search for arrangements that make this possible.

New ideas or social innovations may be usefully introduced in the area of general incomes policy. One such idea is to impose monetary sanctions on decision-makers who deviate from the guidelines established. It has been proposed that enterprises that grant too high wage increases be taxed accordingly (WALLICH/WEINTRAUB [1971]). The problem with this proposal is that it is one-sided and asymmetric. It would be more easily accepted at the constitutional level if the enterprises were to at the same time receive negative taxes (*i. e.* subsidies) when wage increases are held below the guideline levels.

Another new idea worthy of consideration would be to issue licenses allowing price increases of certain sizes (VON WEIZSÄCKER [1975]). These licenses would be tradeable so that those firms keeping prices down would make an extra profit.

As has already been pointed out, control of the supply of money also falls in the domain of constitutional contracts. It is, however, not enough to just call for an independent central bank. Such a solution is undemocratic and, moreover, will not work as interest groups and the political process will put heavy pressure on the central bank which it cannot resist for too long. What is needed is a constitutional arrangement that provides for the possible establishment of an independent central bank as well as other measures.

IV. POSSIBILITIES AND PROBLEMS WITH CONSTITUTIONAL CONTRACTS AS AN APPROACH TO ECONOMIC POLICY

The preceding sections of the paper have suggested that the idea of constitutional contract is practically applicable, and that it may lead to completely different conclusions from those of the traditional technocratic or elitist theories of economic policy. In every society some such constitutional arrangements are already in existence,

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while others still remain to be introduced. There is also room here for utopian ideas that cannot be immediately proposed as constitutional contracts.

While the positive aspects of constitutional contracts should be clear by now, it is also necessary to point out the problems inherent in this approach. There are five major problem areas.

- (a) Is the constitutional contract a useful concept? Is the separation between the constitutional and post-constitutional stages operational? Can the conditions for successful constitutional contracts be brought about by economic policy advisors?
- (b) Can constitutional contracts be maintained under the pressure of strong majorities and vocal, well-organized minorities in the post-constitutional state? This is indeed a basic question. It may be argued that the arrangements will always be broken when it is to the advantage of powerful interest groups. This assertion has, however, not generally been true. A good example to the contrary is the regular and orderly change of parties in power in democratic countries according to written constitutional principles, even though the party in power might have the means at its disposal (police, army) to prevent such a change.
- (c) Organized groups may dominate while unorganized interests are forgotten. This is, of course, always a problem to be reckoned with. In the case of contracts formed on the constitutional level, the opposite may be true: it is relatively easy to bring latent groups to participation in the working out of a constitutional contract with its once-and-for-all character even where they cannot be induced to participate continuously.
- (d) Individuals and organized groups may practice strategic behavior at the constitutional level. This is again a problem which can always arise in social interaction. As has been pointed out, the economic advisor can adopt a counterstrategy, pointing out to the groups that non-cooperation would result in particularly negative effects for them.
- (e) Constitutional contracts will only be arranged by the economic advisors if they have an incentive for doing so. The problem is whether sufficient incentives can be offered and guaranteed. It is also necessary that the advisors have an independent position

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vis à vis interest groups, the public bureaucracy, and government; and that there be competition among the advisors in order to prevent their assuming the role of a benevolent dictator.

V. CONCLUSION

Economic policy-making by constitutional contract faces a number of problems. It has, however, been argued here that the ideas are applicable in the real world and there have already been positive experiences made with existing contracts. It is difficult to see what other possibilities there are for regulating fundamental problems in a democratic society. This approach is a major advance over the existing theory of economic policy, which is simply an application of economic theory unconcerned with political reality. Constitutional contracts mark the beginning of a theory of economic policy which is more than the simple maximization of the social welfare function subject to constraints. The approach has a theoretical base and is at the same time intimately connected with practical economic policy as it emerges out of the politico-economic process in a democracy. Economic policy by constitutional contract may be expected to have a significant impact in the future. For economists, it constitutes a largely unknown area amenable to particularly fruitful research.

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