

I. Introduction to Part III: Ethics, Laws, and Institutions

Part I and Part II of this book demonstrated that a subset of personal ethics affects the scope and scale of commerce. Personal ethics do so by encouraging or discouraging persons from participating in commercial activities and through effects on how they behave when they do so. Honesty and respect for property allow trade to take place at lower risks than would otherwise exist. Trading networks tend to be broader, specialization tends to increase, and commerce tends to become more central to more lives. Civil ethics also contribute to economic development by making life in communities more attractive. They also tend to make organizations work more effectively.

Without such internalized norms, society must rely on external enforcers--managers and the legal system--to solve the various dilemmas associated with life in a community. Yet it is not entirely clear what would motivate the managers, police, and legislators to adopt appropriate rules or follow the rules themselves. For this and other reasons previously discussed, external procedures tend to be less reliable than internal ones. The guilty may escape notice, the penalties miss-targeted, the laws may neglect relevant problems. Without supportive ethical dispositions, every organization's rules would be less binding and less uniformly applied. And, the rules and regulations might fail to promote the rule of law or commercial development, as noted by La Court, Smith, and Bastiat, and implied by More's utopia.

Part III explores the extent to which internalized norms, ethical theories, and moral reasoning affect market-relevant laws, public policies, and institutions. The ethical principles of greatest relevance for Part III are ones that allow policies and social systems to be evaluated. These principles have a long history that stretches back to Aristotle. Aristotle's *Nicomachean Ethics* addresses personal ethics, the principles that produce a better character and life for individuals. Aristotle's *Politics* evaluates the relative merits of alternative political and legal systems. Chapter 2 focused mostly on the *Nicomachean Ethics*, but also included excerpts from the *Politics*. The

former described principles for living a good life. The latter provided principles for identifying a good society.

Part III explores the policy and institutional implications of ethical theories that attempt to identify policies and institutions that can improve an existing society or produce a good society. It focuses on two ethical theories that played significant roles in nineteenth and twentieth century policy debates in the West. Chapter 9 provides an overview of contractarian and utilitarian theories of the twentieth century. Chapter 10 develops some the implications of the applied form of utilitarianism used by economists, welfare economics. Welfare economics implies that a variety of policies that can improve the commercial society. Chapter 11 demonstrates that the public policies recommended welfare economics are unlikely to be adopted without ethical support of voters and government officials. Indeed, ethical theories may be a precondition both for democratic governance and for most of the policies that support commerce.

Chapter 12 explores how ethical dispositions affect rates of innovation and economic growth through effects on private behavior, the performance of institutions, and policies that affect economic development. The idea of continuing economic progress is a relatively new one, partly because significant economic growth is a relatively new phenomenon. What Schumpeter called the "process of creative destruction" raises a number of ethical issues that are relevant for public policy.

If the aim of personal ethics can be thought of as the "good life," the aim of civil or social ethics can be thought of as "the good society." A connection clearly exists between the two insofar as a good society is one in which all (or most) have opportunities to pursue and realize a good life. And, just as individuals and philosophers may disagree about the principles that tend to produce a good life, they may also disagree about the principles that tend to produce a good society. Nonetheless, there are also points of agreement, although not all principles provide support for commerce or a commercial society.

Efforts to develop principles that could be used to evaluate public policies, governments, and social systems emerged in Europe during the seventeenth and eighteenth centuries, a period in which the medieval order

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was being overturned as discussed in chapter 3. Concerns about economic development emerged in the eighteenth and nineteenth century as industrialization began to take place and transform the old largely agricultural and familial routines of life. That Western societies were changing during the eighteenth and nineteenth centuries was obvious to most observers, but whether the changes were improvements or not was less so.

As a consequence, interest in evaluating the relative merits of both public policies and social systems was stimulated among voters, editorial writers, philosophers, and subsequently social scientists (as philosophy divided itself into separate fields of study).

II. Early Contractarianism: Consensus as a Foundation for Legitimacy

The contractarian theory of legitimate governance emerged during the seventeenth and eighteenth centuries. Among intellectuals, the work of Thomas Hobbes (1651) is best known, but there were many precursors to Hobbes. Evidence of this is provided by the many towns and colonies founded via social contract in England's North American Colonies, as with the Puritan colony of Plymouth with its Mayflower compact (1620) and the founding of the colony of Rhode Island and the towns of Providence and Newport (1636). Another precursor can be found in a significant mass movement that campaigned for major legal and political reform with its proposed agreement of the people (1647), written during England's civil war. The Levelers noted advantages that could be realized by forming a government and often included an outline of the governing institutions to be established. The signatories agree to abide by a few fundamental laws and the decision of the government established.¹

That an ideal community is analogous to a private club has a number of implications about its basic laws (both civil and criminal law) and its

procedures for making public policies (democratic or not, representative or not, etc.). Some rules and procedures can be ruled out, because free men and women would never have accepted them. Others may be deemed legitimate (proper), because they tend to advance the broadly shared interests of all members of a community.

The ideal of a contract-based society was subsequently formalized and deepened in books by two highly regarded philosophers of the same century, Thomas Hobbes (1651) and John Locke (1690).

A. Thomas Hobbes 1588-1679

Thomas Hobbes was born into a middle class family, attended Oxford, and worked for the noble Cavendish family in various capacities for most of his adult life. The Cavendishes supported his various intellectual enterprises including one in optics, the law, and political theory. He left England for Paris in 1640 as the English Civil war became as the war of words shifted to one between armies. While in Paris, he wrote a book called the *Leviathan* (1651), parts of which remain influential within political science and among economists interested in the contractarian approach to civil ethics.

The point of departure for Hobbes' theory of contract-based governance is "the state of nature." This hypothetical setting is one in which men are completely free to do what they want. Men and woman in a state of nature may abide by natural law of the Grotius variety or not. They may live productive lives and protect their own lives and property, or they may attempt to enslave others and take their property. Hobbes believes that the latter would be the normal course for human beings.

The result of such unlimited freedom according to Thomas Hobbes is a nasty one, the Hobbesian dilemma in chapter 6. To escape from the resulting war of every man against every other, Hobbes argues that all the persons living in a given territory would agree to a social compact in which many of their natural liberties are surrendered to a community-wide organization, its sovereign government.

¹ Several *Agreements of the People* were drafted during the late 1640s. Most proposed equality before the law and broader representation in Parliament. These proposals both tended to "level" society, by diminishing the extent to which laws and political arrangements favored the nobility and their families. Some of the proposed agreements also supported religious freedom and free trade.

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

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

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

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

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

People would agree to permanently transfer all of their natural authority to a king or parliament because they would expect that a far better life would be realized by doing so. Greater security of life and liberty lead to greater material and intellectual comforts, because the security provided by a strong central government allows human and natural resources to be shifted away from war and into more productive uses.²

In addition, Hobbes suggests that several principles for civil ethics would tend to be internalized by the citizens of a commonwealth (1651, ch. 14-15), because they help to establish and preserve the peace within a commonwealth. Most of these are laws that tend to reduce conflict in order to assure that a community does not revert to the war of every man against every other.

Hobbes' list of civil rights and duties include (1) the right to sign contracts that transfer rights from one person to another, and duty to abide by such contracts (this is necessary to establish a commonwealth), (2) a duty to promote peace and to use violence only in self defense; (3) a duty to abide by the covenant that created the government that allows escape from anarchy; (4) duties on the part of persons receiving gifts to use their gift in a manner that will not cause regrets by the giver; (5) a duty for every man to accommodate himself to the rest, (6) a duty to forgive the past offenses of those who repent (acknowledge guilt and express regrets). Peace within the community would also be more secure if (7) revenge is only be undertaken because of future goods that may be obtained, rather than to reciprocate evil with more evil, (8) if no man by deed, countenance, or gesture expresses hatred or contempt for others in their community, (9) if entrance into the conditions of peace involved an equal transfer of rights to the sovereign and an equal retention of rights for individuals (Not all rights are transferred to the sovereign, because some rights are necessary to live or live well. These include the right to govern one's own body, enjoy air, water, motion, etc.), (10) if all judges and other arbitrators treat the persons who bring cases before them equally, without favoritism, (11) if such things

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

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that cannot be divided are shared in common, and (12) if all men who attempt to mediate conflict are allowed safe passage.³

Hobbes believes that these “are the laws of nature, dictating peace, for a means of the conservation of men in multitudes, and which only concern the doctrine of a civil society.”

The Laws of Nature are Immutable and Eternal, For Injustice, Ingratitude, Arrogance, Pride, Iniquity, Acception of persons, and the rest, can never be made lawful. For it can never be that War shall preserve life, and Peace destroy it. (*Leviathan*, p. 88).

Note that the right of contract is the first natural law, because a commonwealth emerges from the consent of the governed. Without the ability to formally transfer rights, a commonwealth is impossible. The right to contract is also a right that cannot be fully transferred to the government without eliminating the voluntary nature of a commonwealth’s government or the possibility of market exchange.

For Hobbes, the social contract was essentially a once and forever agreement that established the procedures for choosing policies (one man or one assembly).

[T]hey that are subjects to a Monarch, cannot without his leave cast off Monarchy, and return to the confusion of a disunited Multitude; nor transfer their Person from him that beareth it, to another Man, or other Assembly of men: for they are bound, every man to every man, to Own, and be reputed Author of all, that he that already is their Sovereign, shall do, and judge fit to be done. (*Leviathan*, p. 97).

Hobbes did acknowledge limits to the transfer of authority.

The Obligation of Subjects to the Sovereign is understood to last as long, and no longer, than the power lasteth, by which he is able to protect them. (*Leviathan*, p. 123).

If the government fails to generate law and order, or is determined to destroy life and property rather than protect them, the social contract is breached and is null and void. However, neither covenants nor contracts can be unilaterally abridged. Similar remarks are found two centuries later in Kant’s theory of governance (1792).

Other contractarians argued that the voluntariness of the social contract implied sharper limits on the form of government and the policies that a government could legitimately adopt. This is largely because their characterization of the natural state is less dismal than that provided by Hobbes.

B. The Lockean Social Contract: Agreement among Free Men

Locke (1690/2011), like Hobbes, was also an employee of a noble family for most of his adult life and in his theory of a civil society, also begins his theory of government with the natural state, but he regards the natural state to be far less nasty than Hobbes did, possibly because of the experience of England’s North American colonies. He does not provide a list of civil norms as Hobbes does, but does more fully describe the limited scope of a government based on the consent of the governed.

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

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

³ Other rules of conduct may advance religious aims or personal ones, but these are ones that support peace and civil society. He goes on to mention that his list is incomplete. There are other actions that can undermine peace within a community, such as drunkenness and other forms of intemperance, that community norms and its formal laws would also address. Chapter 18 lists the rights of a sovereign person or parliament.

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

[Government's] **power, in the utmost bounds of it, is limited to the public good of the society.** It is a power, that **hath no other end but preservation,** and therefore can **never have a right to destroy, enslave, or designedly to impoverish the subjects.** (*Second Treatise of Government*, p. 51)]

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

THE *great end of men's entering into society, being the enjoyment of their properties in peace and safety,* and the great instrument and means of that being the laws established in that society; the first and fundamental positive law of all commonwealths is the establishing of the legislative power; as the first and fundamental natural law, which is to govern even the legislative itself, is the preservation of the society, and (as far as will consist with the public good). (*Second Treatise of Government*, p. 50).

Voluntariness implies limited rather than absolute government. With respect to public policies, it implies that some policies are legitimate and others not. For example, a government may not enslave its citizens or impoverish them.

The reason why men enter into society, is the preservation of their property; and the end why they choose and authorize a legislative, is, that there may be laws made, and rules set, as guards and fences to the properties of all the members of the society, to limit the

power, and moderate the dominion, of every part and member of the society: for since it can never be supposed to be the will of the society, that the legislative should have a power to destroy that which every one designs to secure. ...

Whenever the legislators endeavor to take away, and destroy the property of the people, or to reduce them to slavery under arbitrary power, they put themselves into a state of war with the people, who are thereupon absolved from any farther obedience. (*Second Treatise of Government*, pp. 82-83).

To attempt to enslave the citizenry would be a violation of the social contract--and thus illegitimate and immoral. The signing of a social contract implies that all signatories expect to be at least as well off after the community is founded as before. If they are not, no meeting of the minds occurred, and no contract was truly entered into.⁴

Note both Hobbes and Locke argue that human rights are natural and prior to the formation of a government. The right to contract and own property are not creations of the state, but preconditions for forming a state. Without a prior right to contract, there could be no social contract-based theory of the state or legitimacy. If life and property were secure without a law making and enforcing organization, there would be little need for such organizations. The same rights that make commerce possible are also necessary to establish a legitimate government from a contractarian perspective.

Note also that laws are not coercive when governments are formed in this way, unless they violate the social contract. The authority to create and enforce laws is voluntarily shifted to a central authority as method for reducing conflict within a community and promoting its development. Government is a means rather than an end. Its main purpose, according to both Hobbes and Locke, is the security and safety of members of the community. To advance this shared end, a government is organized and delegated authority to adopt and enforce appropriate laws.

⁴ Locke's (1689) reasoning clearly played a role in the arguments of declaration of independence written in Philadelphia in 1776 by the leaders in of the United States' war of succession from the United Kingdom.

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To evaluate the appropriateness of specific laws and public policies, contractarian attempt to determine whether broadly shared interests are advanced by those laws. In other words, would members of a community have agreed to include this law or the procedure that gave rise to it into a social contract. If the benefits are broad and obtained at a reasonable cost, then the institution or policy is consistent with an implicit social contract. If not, a law or public policy can be said to be unjust or illegitimate, because it is not consistent with the contractual basis for government.

Contractarian theory was widely used in the West during the eighteenth and early nineteenth century, which can be seen in legal and political theory (Blackstone [1758]⁵ and Rousseau [1762]⁶) and in the preambles of several constitutions written during this period.⁷ Interest in the contractarian approach declined during the nineteenth century in large part because of utilitarian critiques of its use of “fictional” contracts for purposes of normative analysis. It was reinvented and reenergized in the second half of the twentieth century by the philosopher John Rawls and economist James Buchanan.

C. Utilitarian Critiques of Early Contractarianism

The general framework of utilitarianism has already been introduced and many of its implications for personal behavior elaborated, although not its implications for public policy. When applied to public policies, the

normative question remains, as always: “Is aggregate utility increased by an action or not?” This is a question that in principle should be answered in the affirmative for every new law, regulation, or public policy.

Contractarian logic is largely compatible with the utility principle. A policy that is adopted unanimously tends to increase aggregate utility. Every one that agrees to a social compact expects to be better off because of it. There may be mistakes, as in any part of life, but as long as the anticipated results are on average realized, the result of a unanimous agreement, as with an ordinary exchange, is an (expected) increases aggregate utility. However, Bentham dismissed contractarian theories of law and government as “nonsense on stilts,” because of their fictional natural law and consensus foundations.⁸

Utilitarians do not require everyone or nearly everyone to benefit from a policy, nor do they require the fiction of a social contract, only that the total benefits of an action or new policy be greater than their total costs in terms of happiness or utility. This simplifies their analysis and allows sharper conclusions about both individual policies and actions. It also implies that utilitarian policies are easier to implement than contractarian ones, once they are determined. As long as those advantaged by a policy gain more than others lose, the policy is a good one. Contractarians would require the losers to be compensated for their losses in order to obtain (or

⁵ Blackstone (1758) develops a theory of law that included three sources of law: natural, revealed, and mutual compacts. Municipal law and international law were instances of the latter: “municipal or civil law regards him also as a citizen, and bound to other duties towards his neighbor, than those of mere nature and religion: duties, which he has engaged in by enjoying the benefits of the common union: and which amount to no more, than that he do contribute, on his part, to the subsistence and peace of the society (KL 813-16).”

⁶ Rousseau (1762) explicitly links constitutional design to the ethical dispositions of a community’s citizenry: “Just as invalids are not suited for a healthy person’s diet, so too we must not try to govern a corrupt people by laws that suit the virtuous. The best proof of this principle is the longevity of the Republic of Venice, which in outward appearance still exists, solely because its laws are only suited to men of bad character (p. 150).”

⁷ The preamble of the American constitution uses contractarian ideas about the nature of government: “We the People of the United States, in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defense, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity, do ordain and establish this Constitution for the United States of America.” Many of the European constitutions adopted during the eighteenth and nineteenth centuries were also grounded in contractarian theories of legitimacy.

⁸ Bentham’s devastating remark was aimed at Blackstone’s (1758) *Commentaries on the Laws* of England, but applied to all of natural law based and contractarian analysis, both of which were grounded in convenient fictions.

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approximate) unanimous agreement. Such differences help explain why utilitarian analysis replaced contractarian analysis in the nineteenth century.

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

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

Ask each one his reasons. You will find a strange diversity of sentiments and principles: you will find it not only among the people, but among the philosophers. Is it lost time to seek for a uniform base of agreement upon so essential an object?

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

We appeal, then, here to the principle of utility: it confirms the decisions of prejudice wherever they are just; it annuls them wherever they are pernicious. (*Collected Works of Jeremy Bentham*, KL 8180-8190).

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

Bentham argues that evaluating policies and institutions by their effects on aggregate utility also tends to promote a more complete understanding of the effects of policy.

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

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

The clarity of utilitarian analysis is, however, easy to exaggerate. Contractarians criticize utilitarians by pointing out that utility and aggregate utility are also convenient analytical “fictions:” imaginary personal and social indices that facilitate utilitarian normative analysis. They also note that immoral conclusions can follow from utilitarian reasoning that ignores basic human rights or that supports public policies that do not advance universally shared interests.

As noted by Spencer and many others, utilitarian analysis of long term policies also requires stable personal assessments of pleasure and pain (utility) in the period of interest. One also needs to know the consequences of policy choices and the utility levels of all affected individuals. Both are demanding requirements when utility is to be measured in subjective terms, as “utils.”

D. Utilitarian and Contractarian Theories and Reform in the Nineteenth Century

It bears noting that the reform agendas of contractarians and utilitarians in the nineteenth century were nonetheless broadly similar during the late eighteenth and the nineteenth centuries, in spite of their differences. Both approaches were secular, inclusive, analytical in their analysis of public policy issues. Their conclusions thus tended to be pro-free trade, pro-education, pro-infrastructure, and anti-privilege, because such policies tended to open up opportunities for a far broader cross section of individuals, families, and organizations than medieval rules had allowed.

To promote the changes in public policy and law necessary to advance those ends, many utilitarians and contractarians were politically active. They wrote politically oriented editorials, pamphlets, and books. They founded policy oriented magazines and newspapers. They engaged in lobbying campaigns in public (with organized speeches and debates), and in private,

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where their efforts were often supported by sympathetic persons in government. A few ran for elected offices.

Together with new theories of the self-regulating nature of markets and gains to trade, these normative theories helped produce broad support within the middle and upper middle class for policies of government neutrality and noninterference during the nineteenth century: the separation of government and religion, and the separation of government and economics.

Legal privileges and preferences for churches, families, towns, and particular markets were gradually reduced or eliminated, partly because these were deemed unethical or unjust by voters. Tariff protection for various industries were reduced during the first half of the nineteenth century throughout Europe. Infrastructure was expanded.⁹

These and related policies also tended to reduce the legal impediments to commerce and broaden the markets that could be supported by a single factory or company. Together with technological innovation, shifts in personal ethical dispositions, and entrepreneurship on the part of thousands of individuals and organizations, these reforms helped launch the industrial revolution and the commercial society. More extensive trading networks emerged, larger enterprises were organized, and specialization increased. Capitalism in the modern sense emerged.

The political effects of nineteenth century reforms were also obvious. In 1800, elections in Europe were not very important or open procedures. By 1900, elections and elected officials dominated the law-making process in most of Western Europe and were increasingly important in Japan. The

same could be said of political and economic reforms in Canada, Australia and New Zealand. Competitive elections had been important in the United States from fairly early in its colonial days, but even there property, race, and religious qualifications were eliminated. Women were added to the electoral roles in the early twentieth century. The places that adopted liberal reforms industrialized and democratized, those that did not, did not.

Shifts in civil ethics also favored equality before the law, just deserts, and progress over privilege and tradition. Insofar as arguments based on these ethical principles were important in policy debates, the new institutions and more extensive markets of the late nineteenth century could be said to have moral foundations. Where utilitarians and other liberals lost the policy debates of the nineteenth century, as in China and Turkey, industrialization was more limited and democratization even more so. Shifts in personal ethics and other norms clearly played a central role in this transformation. They had made innovation and commerce more acceptable.

Of course, neither history nor commercialization ended in 1920.

III. Welfare Economics: Utilitarianism for Policy Analysis

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

⁹ Many of these reform were passed by what Yandle (1983) refers to as bootlegger and Baptist coalitions, coalitions of persons who expected to profit from the reforms together with idealists (here often utilitarians and contractarians) attempting to promote the public interest.

Pragmatists did not simply argue (at least in public) that policy X will make me richer or more powerful, but that policy X will advance general interests. Desired reforms would make us all better off by creating better opportunities for the pursuit of happiness (more employment opportunities) than the status quo allowed. Opponents would appeal to tradition or argue the opposite, that proposed policies will make us all worse off. Neither group of pragmatists would have used arguments grounded in ethics unless those arguments were thought to more persuasive than pure self interest arguments. They would not have been persuasive unless many voters and policy makers had already internalized the norms used to support or oppose particular policies.

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lifestyles and institutions. Former lifestyles were increasingly difficult to imagine or approve of.

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

The older normative ideas did not entirely disappear; instead they were often used to support new ethical theories, especially those that emphasized duty over reason and self-development. Among these were communist and fascist theories of the good life and good society. The new theories were top-down rather than bottom-up systems, somewhat in the spirit of More’s *Utopia* or Plato’s *Republic*. Several major twentieth century wars arguably had their roots in new ethical challenges to the normative theories that had supported the emergence of the commercial society and democratic politics.

Determining the relative merits of major policy reforms and social systems requires a normative theory that is independent of the systems themselves. One cannot, for example, say that majority rule is the best political system because a majority of voters supports it. Utilitarian philosophy conceptually provided such a method for evaluating both major and minor reforms based on their effects on aggregate utility. However, as Spencer and others pointed out, doing so in practice was not always possible.

To counter the new ethical arguments and address problems with contractarianism and utilitarianism, philosophically oriented economists, political scientists, legal scholars, and philosophers extended utilitarian and

contractarian arguments and developed new methods for evaluating economic and political institutions and their associated patterns of life.

A more operational version of utilitarianism was worked out by Arthur Pigou in the early twentieth century, and was subsequently widely adopted by economists and policy analysts. Alfred Pigou’s creation of a more operational utilitarianism came to be called “welfare economics,” in part because it focuses on economic welfare, broadly interpreted. Pigou argued that in many cases changes in aggregate economic welfare could be used to approximate changes in aggregate utility. Another response to the criticisms of Spencer and others was the reinvigoration of contractarian philosophy, a line of reasoning that had died out in the late eighteenth century. Several innovations in contractarian analysis were developed by John Rawls and James Buchanan in the second half of the twentieth century. Both of these twentieth century innovations tended to support the commercial society, albeit with reservations.

In addition, some of the feasibility arguments used by Aristotle to criticize Plato’s idealized state were re-employed.¹⁰ The feasibility of alternative visions of the ideal society were called into question. Could centrally run utilitarian economies achieve as much material comfort as that associated with a commercial society? Would the rulers of authoritarian regimes have internalized personal and civil ethics that would produce ideal societies—however imagined? Or, were the persons who rose to the top of those authoritarian societies more likely to be power-seeking, personal wealth-maximizing pragmatists than utilitarians?

Major twentieth century developments in applied utilitarianism and contractarianism are illustrated with four influential scholars: two prominent early twentieth century economists, one a left liberal and the other a right liberal, and two late twentieth century contractarians, one a left liberal philosopher and the other a right liberal economist. Applications of their theories to policy, institutional, and system analysis are taken up in chapters ten and eleven.

¹⁰ The chapter 2 reviewed several of Aristotle’s critiques of Plato’s ideal state, the *Republic*, including both critiques of specific features of Plato’s ideal society and the feasibility of his idealized authoritarian regime, with its philosopher king and guardian class. Digitized translations of Plato’s *Republic* are available on the internet.

A. Alfred C. Pigou (1877-1959)

Alfred Pigou was raised in an upper middle class family in England and educated at Harrow School and Cambridge University. His academic training was in moral philosophy, history, and economics, which he learned from Alfred Marshall. He became professor of political economy in 1908, a position that he held until 1943. His most important work is his book, *The Economics of Welfare* (1920), which develops a new utilitarian-based economic tool bag for policy analysis that would later be referred to as welfare economics. Pigou combines utilitarian reasoning and neoclassical economics in a manner that provides new operational methods for appraising the relative merits of the outcomes of various types of markets and public policies.

Pigou was more critical of commercial activity than Bentham or Spencer, but nonetheless, begins by arguing that gross national product (the social dividend) can be used as a proxy for aggregate utility. He also provided utilitarian rationales for government interventions in markets to address externality and monopoly problems, analogous to those suggested by Mill. The latter was a challenge to the doctrinaire liberals of the Spencer variety in the early twentieth century, who argued that such interventions violated the equal liberty principle and freedom of contract. Pigou argued that such interventions could make a commercial society more attractive than it would have been without them.

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

It is not, indeed, possible to separate it in any rigid way from other parts, for the part which can be brought into relation with a money measure will be different according as we mean by can, “can easily” or “can with mild straining” or “can with violent straining.” (*The Economics of Welfare*, KL: 295-300).

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

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

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

The extent of commerce itself is correlated with aggregate utility. Given this, the greater the extent of the commercial society, the greater is aggregate utility, other things being equal. This provided a new utilitarian basis for supporting commerce, the commercial society, and the extension of commerce. This money-based index of aggregate utility had a implications for public policy, but not all of them consistent with the *laissez faire* approach that had become mainstream among economists in the late nineteenth century. In other words, commerce is a good system, but it may not be the best system possible.

Having made a general argument in support of commerce, Pigou shifts his attention to various aspects of commerce that do not tend to maximize aggregate utility. He next argues that the wealth and income that are generated by commerce tend to increase aggregate utility but not to

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maximize it. The logic of diminishing marginal utility implies that redistribution from the rich to the poor can increase aggregate utility, whenever it can be done without reducing GNP.¹¹

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

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

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

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

Although policy-orientated utilitarians often neglect the importance of internalized ethical dispositions, Pigou does not entirely do so, noting that what he refers to as the social virtues are imperatives for life in a community. As a utilitarian, he naturally emphasizes those that are most

important for utilitarian outcomes: honesty and taking account of how one's behavior affects the entire community.

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

Honesty becomes imperative, and is enforced by the whole group on the individual, loyalty to the whole group is made an essential for the better development of individual powers. **To cheat the society is to injure a neighbor.** (*The Economics of Welfare*, KL: 376-379).

When GDP is accepted as a measure of the goodness or attractiveness of a good society, the main issues are ones associated with increasing the scope of the commercial society. Nonetheless, Pigou's approach implies that some adjustments at the margin are called for. The extent of aggregate utility can be increased by promoting social virtue, internalizing externalities, and modest redistribution.

A variety of issues are associated with Pigou's analysis of how public policies could improve the commercial society. What are the externalities that should be internalized? How much redistribution can be undertaken without undermining the social dividend? To what extent can government be expected to pursue utilitarian ends? These were taken up later in the century.

As a consequence of Pigou's analysis and extensions of it, the appropriate role for government among twentieth-century utilitarians tends to go well beyond that advocated by many nineteenth century liberals: maintaining law and order, a bit of infrastructure investment, and support for basic education. Pigou's analysis shifted the debate from gains-from-trade-based arguments to cost-benefit analysis. Does a policy produce more aggregate benefits (measured in dollars or some other

¹¹ The modern terms gross national product and GNP are used rather than social dividend, because they are more familiar to readers and have essentially the same meaning. The notion of a social dividend had been introduced by Alfred Marshall. Pigou subsequently played a role in the development of the macro-economic measure that came to be known as GNP. See Chipman and Moore (1976) for a short critique of GNP as a proxy for aggregate utility.

currency) than it generates in costs. If so, those policies will increase the national dividend (GNP) and are very likely to increase aggregate utility.

B. Ludwig von Mises (1881-1973)

Ludwig von Mises was raised in a noble Jewish family in the Austrian-Hungarian empire that had been involved in financing and constructing of railroads. He was educated at the University of Vienna, and initially worked in Austria's department of the treasury. He was active in Austrian politics, serving as an economic advisor to various organizations. He subsequently taught at the Graduate Institute of International Studies in Geneva Switzerland and New York University.

Mises spent much of his adult life defending the market system and criticizing alternatives proposed by those he termed socialists. For Mises, this included the broad range of philosophers, economists, politicians, and voters that opposed private ownership of capital and also most of those who favored centrally managed economic systems. His arguments were less influential among economists and policy makers than those of Pigou in the English speaking world, although they had broad impact worldwide. His articulation of liberal principles and defense of what he refers to as capitalism were among the most persuasive and well known in the mid-twentieth century.¹²

He challenged many of Pigou's conclusions about redistribution, not by rejecting welfare economics, but by arguing that policies that change in distribution of income or revise fundamental legal institutions, such as the private ownership of land and capital, would significantly reduce the national dividend. One cannot simply assume that GNP will not be reduced by such changes.

Those who advocate equality of income distribution overlook the most important point, namely, that the total available for

distribution, **the annual product of social labor, is not independent of the manner in which it is divided.**

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

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

As true of Pigou, Mises' analysis spent relatively little time on private ethics and focused on public policy issues, especially those proposed by opponents of privately owned land and capital. Nonetheless, he argues that moral conduct helps make a civil order possible. His theory of morality draws implicitly on both utilitarian and contractarian ideas.

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

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

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

¹² Ludwig von Mises' book (1927) *Liberalism* was written in a period in which profound changes were taking place in the German speaking world, including his native Austria. The royal systems of Germany and Austria disintegrated at the end of World War I and were replaced by new republican governments dominated by social democrats (most of whom could be considered left-liberals). Law and order broke down in many places as conservative regional governments resigned and were replaced with various types of radical reformers including communists. Markets were disrupted and ideological debates raged in parliaments and in the streets. *Liberalism* attempts to remind readers of the reasoning behind support for markets.

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

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

The continued existence of society as the association of persons working in cooperation and sharing a common way of life is in the interest of every individual. (*Liberalism*, pp. 33-34).

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

Society is to be taken into consideration in every action, not to maximize aggregate utility, but because everyone in a community benefits from internalized rules of conduct that reduces conflict and promotes productive activities, as argued by Locke and Hobbes.

He reminds readers that private property, including the private ownership of capital, plays a central role in the prosperous societies that had emerged in the previous century, and therefore should be regarded as a moral institution.

In seeking to demonstrate the social function and necessity of private ownership of the means of production and of the concomitant inequality in the distribution of income and wealth, **we are at the same time providing proof of the moral**

justification for private property and for the capitalist social order based upon it. (*Liberalism*, p. 33).

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

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

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

Although von Mises is often associated with contemporary libertarianism in the United States, he was not an anarchist as is sometimes seems to be suggested by his fans, but a right-of-center liberal. With respect to anarchism, his argument parallels that of Hobbes and many others. Mises simply updates and sharpens what critics in the nineteenth century referred to as "doctrinaire liberalism."

Liberalism is not anarchism, nor has it anything whatsoever to do with anarchism. The liberal understands quite clearly that without resort to compulsion, the existence of society would be endangered and that **behind the rules of conduct whose**

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observance is necessary to assure peaceful human cooperation must stand the threat of force if the whole edifice of society is not to be continually at the mercy of any one of its members.

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

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

Mises, in contrast, argues that the benefits of a commercial society are greatest when governmental authority is restricted to the limited domain supported by Locke, Smith, Bastiat, and Spencer. This is partly because markets are efficient producers of material comforts and partly because of the nature of democratic politics, which he argues tends to favor narrow over general interests.

There are a great number of parties, and each particular party is itself divided into various subgroups, ... **Each particular party and faction feels itself appointed to be the sole champion of certain special interests**, which it undertakes to lead to victory at any cost.

To allot as much as possible from the public coffers to “our own,” to favor them by protective tariffs, immigration barriers, “social legislation,” and privileges of all kinds, at

the expense of the rest of society, is the whole sum and substance of their policy. (*Liberalism*, p. 171).

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

Their differences were and are also important, as the many heated policy debates that took place in the West during the second half of the twentieth century affirm.

IV. The Rebirth of the Contractarian Ethics

The early contractarians were among first to suggest that the interests of all citizens should be taken into account when evaluating institutions. Contractarian analysis uses the consent of all members of a community to establish the legitimacy of governments and their associated systems of laws and public policies. Contractarians maintain that the grounding laws and political institutions of a society are delegations of authority from individuals to organizations created to advance their common interests. Individuals give up some of their liberties in exchange for others doing the same thing in order to realize a far better society than they would have without government, as argued by Hobbes, Locke, and Mises.

After WWII, two other major scholars began casting doubt upon the logic and appeal of utilitarian analysis and welfare economics. One was among the best known philosophers of the post-war period, John Rawls; the other won a Nobel Prize in economics, James Buchanan. They criticized both the conclusions reached and the utilitarian method of reaching those conclusions. Both emphasized agreement as the foundations for a good or just society, rather than the maximization of aggregate utility. Both

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emphasize two-stage modes of analysis, what Buchanan termed the constitutional and post constitutional periods.

The rebirth of contractarianism was arguably a consequence of weaknesses in the dominant utilitarian approach to public policy analysis. Philosophers and economists who were troubled by the measurability of utility, tend to be drawn to contractarianism because it retains much of the appeal of utilitarianism (everyone counts and counts equally) without requiring interpersonal comparisons of utility or measurable indices of utility. Contractarian theory does not require interpersonal comparisons or arithmetic calculations using the utility levels of all individuals in the community of interest.¹³ Those who favored non-coercive relationships of markets over coercive ones of legislation and law enforcement would also be drawn to the voluntarism of the contractarian approach. Political theorists who are not necessarily advocates of markets were also drawn to it for its clear arguments concerning the ultimate foundations and limits of government authority.¹⁴

A. John Rawls (1921 - 2002)

John Rawls was raised in an upper class Baltimore family, educated at a boarding school in Connecticut and at Princeton University, where he received a Ph. D. in philosophy in 1950. He taught at Harvard University for most of his career. He is best known for his classic re-grounding of contractarianism, *A Theory of Justice* (1971). In that book he proposes an alternative to the utilitarian framework, one is similar in spirit to early contractarian theories of government, but different in manner of argument and emphasis. He argued that an philosophical alternative to utilitarianism is

necessary because utilitarianism lacks a defense of fundamental human rights or democratic government.

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

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

The ideal outcome would be that these conditions determine a unique set of principles; but I shall be satisfied if the suffice to rank the main traditional conceptions of social justice.

[John Rawls (1999) *A Theory of Justice*. Harvard University Press. Epub edition, page 14.]

Rather than rely on the Hobbesian natural state arguments of seventeenth and eighteenth century contractarians, he calls on readers to imagine another setting, one in which they do not know who they will be in a future society that emerges after basic principles and institutions are chosen. From behind this "veil of ignorance," readers are asked to assess the relative merits of alternative principles of justice, based on their own evaluation of the lives associated with societies that would emerge from institutions consistent with those principles.

¹³ Welfare economics generalized Bentham's additive aggregate utility measure to include other functional forms, not all of which involve arithmetic, but all of which involve aggregation and most of which involve interpersonal comparisons of utility. See, for example, Bergson (1938), Graaff (1957), and Sen and Williams (1982). Bentham's additive form, however, remains one of the most commonly used, and continues to ground for cost-benefit analysis and most of normative public economics.

¹⁴ The idea that one could add up utilities is methodologically inappropriate, if utility is regarded as simply an analytical convenience, rather than a model of the human mind or happiness. Moreover, utilitarian analysis often, although not always, leads to conclusions that conflict with moral intuitions and also with ideas at the heart of contractarian political theory. For example utilitarianism can be used to rationalize killing a healthy person for his "body parts" in order to keep a dozen people alive. Such conclusions violated what Spencer and Rawls called the equal liberty principle and also violate the natural law theories of early contractarians.

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Rawls assumes that individuals choose a principle of justice that advances both their material and moral interests, a representation of human interests similar to that used in part II of the present volume. In the context of the veil of ignorance, moral interests are similar in spirit to Grotius' characterization of natural law or Spencer's characterization of a moral sense. Everyone shares an innate capacity for making moral assessments. The similarity of everyone's moral and material interest produce agreements about principles of justice, which in turn limit the range of possible just institutions.

He argues that a consensus would emerge from behind the veil of ignorance with respect to both principles of justice and the core institutions of society.

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

Since all are similarly situated and no one is able to design principles to favor his particular condition, the principles of justice are the result of a fair agreement or bargain. ...

This initial situation is fair between individuals as moral persons, that is, as rational beings with their **own ends** and **capable, I shall assume, of a sense of justice.** (*A Theory of Justice*, pp. 8-9).

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

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

Second: social and economic inequalities are to be arranged so that they are both (a) **reasonably expected to be to everyone's**

advantage, and (b) attached to positions and office open to all. (*A Theory of Justice*, p. 50).

Note that two of the three (1 and 2b) are equal liberty provisions similar to those supported by Spencer and Mill in the previous century, and Hobbes three centuries earlier. The third (2a) concerns economic inequalities, the area in which Rawls' conclusions are the most famous outside of philosophy.

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

The basic rights and liberties ... guarantee equally for all citizens the social conditions essential for adequate development and the full and informed exercise of their two moral powers, their capacity for **a sense of justice** and their capacity for **a conception of the good.** (*A Theory of Justice*, p. xiv).¹⁵

Equal liberties enable individuals to develop their moral capacities, in a manner analogous to Aristotelian investments in moral excellence. The equal liberty and distributional principles, in turn, are used to assess the relative merits of a society's grounding institutions, such as markets and democracies.

With respect to political institutions, Rawls reaches conclusions in the spirit of Locke, Mill, Pigou, and contemporary welfare economics. Governments have a role in providing law and order, pure public goods, internalizing externality problems, and addressing problems associated with monopoly.

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

¹⁵ This quote from the preface refers to an argument developed at length in Rawls (1982).

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

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

Which of these systems and the many intermediate forms most fully answers to the requirements of justice, I think, be determined in advance. There is presumably no general answer to this question since it depends in large part upon the traditions, institutions, and social forces of each country...(*A Theory of Justice*, , pp. 237-240).

Although markets are useful, he argues that markets tend to be used under both property owning and liberal socialist regimes.

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

A just constitution **must rely to some extent on citizens and legislators adopting a wider view** and exercising good judgment in applying the **principles of justice.** (*A Theory of Justice*, p. 315).

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

With respect to markets as systems for distributing the social dividend, however, he is less clear because of implications of the first part of his second principle of justice (2a). Here he argues that inequality would be

acceptable only if it increased the welfare of the least advantaged, what many refer to as Rawlsian difference or maximin principle.

Assuming the framework of institutions required by equal liberty and fair equality of opportunity, **the higher expectations of those better situated are just if and only if they work as part of a scheme which improves the expectations of the least advantaged** members of society. (*A Theory of Justice*, p. 63).

A commercial society can be completely compatible with the equal liberty principles (1 and 2b). However, whether market outcomes satisfy the difference principle depends on the view of markets that one takes. If one accepts reasoning analysis to that of von Mises, one could argue that markets satisfy that principle as well. Without its grounding institutions--private property and freedom of contract--everyone would be much poorer. Alternatively, if one accepts Pigou's reasoning, governmental policies can improve on the results that tend to emerge under 19th century civil law, by internalizing externalities, solving public goods problems, and engaging in redistribution. Given one or the other theories, Rawls argues that a consensus regarding principles of justice has clear implications for just legal and political institutions and for major public policies. Rawls himself clearly uses a theory of markets similar in spirit to that of Pigou.¹⁶

B. James M. Buchanan (1919-2013)

James Buchanan was raised in an upper middle class family in Murfreesboro Tennessee, where he attended public schools, Middle Tennessee State University, and the University of Chicago, where he received a Ph. D. in economics in 1948. He spent most of his academic life at three Virginia universities, beginning with the University of Virginia in 1956 and ending at George Mason University in 2000. He was trained as an economist in the era before mathematics and statistics became central parts of graduate training, which was partly responsible for his broader philosophical interests.

¹⁶ In the absence of consensus about both principles of justice and economic theory, there is likely to be far less consensus about standing institutions and public policies. In this respect, Rawls' approach shares a conceptual weakness with earlier contractarian theories of the state.

From the beginning of his academic career, Buchanan was very concerned about philosophical issues in economics, especially the evaluation of public policies and political institutions. He criticized utilitarian and social welfare economics, challenging them on a variety of grounds including the instability and incompleteness of preferences and the non-commensurability of preferences orderings during periods in which they are stable (1954). He also challenged the implicit assumption of welfare economics that governments would follow the advice of utilitarian economists. One cannot simply add utility levels or functions up, nor can one simply assume that policy makers are entirely benevolent.

His contractarian bears a closer resemblance to the classic works of contractarianism than Rawls' theory, in that he work includes analysis of implication of Hobbesian anarchy for contract-based theories of the state, *Limits to Liberty* (1975). However, for the most part, he takes the contemporary status quo as the point of departure and analyzes whether people might plausibly agree to particular policies and institutional reforms. He uses rational choice models rather than surveys to determine whether there mutual advantages exist for particular reforms of public policies or political institutions. He also stresses that both policy and institutional reforms emerge from bargaining, rather than from the recommendations of welfare economists or other experts.

For the purposes of this chapter, his last book length treatment of issues associated with contractarianism is focused on, *Politics by Principle, Not Interest* (1998).¹⁷

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

The rules for living together - the basic law and political structure - are, quite literally, made up or created in some participatory process of discussion, analysis, persuasion, and mutual agreement.

In this conception of social order, the constitution, inclusively defined, emerges from agreement among those who must abide by the constraints contained within it.

The constitutional stage, which involves both law and politics, is understood and described best in terms of an exchange of agreements among participating members of the community. Persons agree to constraints on their own liberties in exchange for comparable constraints being imposed on the liberties of others.

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

To the contractarian the question posed is: Could the existing set of rules have emerged from the agreement among all parties who are currently subject to them? Or, in individualistic terms, the proper question is: Could I have agreed to the set of rules that the existing political-legal structure represents? [Buchanan and Congleton (*Politics by Principle Not Interest*, p.4-5).]

Note that according to Buchanan exchange occurs within democratic politics as well as in markets. The bargaining involves rules, taxes, and expenditures, gains to trade among legislators and voters, and the bargains struck determine what emerges from politics, just as similar agreements determine what emerges from markets. Rights to bargain and contract are, as in Hobbes, preconditions for a constitutional state.

Buchanan, like Rawls, also relies upon a “veil” to motivate agreement. In his case, the veil is a natural consequence of the uncertainty associate with long-run planning, rather than an imaginary initial position used to

¹⁷ Although the book was coauthored with the author of the present volume, the quotes are taken mainly from the chapters that Buchanan wrote and so are attributed solely to him.

identify principles of justice. He argues that the long term nature of constitutional decisions tends to generate uncertainty because our natural ignorance about the future. This induces persons consider a variety of possible outcomes when assessing the consequences of grounding laws and major reforms.

The veil of ignorance and/or uncertainty offers a means of bridging the apparent gap between furtherance of separately identified interests and agreement on the rules that conceptually define the “social contract.” Potential contractors must recognize that the basic rules for social order - **the ultimate constitutional structure - are explicitly chosen as permanent or quasi-permanent parameters within which social interaction is to take place** over a whole sequence of periods.

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

Buchanan was less willing than Rawls to argue that a particular consensus would emerge. Although he had strong classical liberal normative disposition, he thought it presumptuous to declare his “preferences” to be the truth. Rather, he regarded his opinion about the matter to be simply one of many that would be taken account of during constitutional bargaining.

Politics by Principle Not Interest also develops a new pragmatic defense of universality and equality before the law. The basis of its generality argument is quite different than the one developed by Kant, Spencer, or Hobbes. Given a democratic polity, with its possible majoritarian cycles, generality can make everyone simultaneously better off by reducing the frequency and extent of majoritarian cycles.¹⁸

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

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

[The Generality] norm, if operative as a constitutional constraint, ensures that the “all-encompassing interest,” reflected in **the maximal value of produce**, as evaluated by the preferences of participants and subject to the transfer proviso discussed later, will be chosen as preferred by any coalition in a position of collective authority.

In effect, **the constitutionalization of generality in treatment indirectly amounts to the constitutionalization of market allocation in settings in which public goods and externalities are not present.** (*Politics by Principle Not Interest*, p.76.)

Buchanan, like Rawls, accepts the conclusions of welfare economics with respect to public goods and externalities, although not their method of reaching those conclusions. Public goods and externalities are areas of life in which citizens might agree to task governments with responsibilities to intervene in markets, because they would expect to benefit from policies that addressed those problems.

However, if there are no externalities or public goods problems, then the commercial society is not to be interfered with, because doing so tends to violate the generality principle. To do so would generate more political instability than desirable and greater economic uncertainty than necessary, conclusions that are not so different from Spencer’s criticism of the early regulatory and transfer programs of England.

V. A Contractarian Illustration: Choosing Institutions from Behind the Veil Based on Distributive Concerns

To illustrate the differences between Rawls’ difference principle, Buchanan veil of uncertainty principle, utilitarianism and egalitarianism,

¹⁸ An extension of that argument implies that democracy is dependent on the rule of law and unlikely to survive without it (Congleton 1997).

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consider the following choice setting. Suppose that there are three types of persons and four types of institutions. Suppose that one can characterize the net effect of an institution on a particular person with a single number, which can be regarded as either personal wealth, happiness, or lifetime utility. In both Rawls' and Buchanan's framework, the numbers would represent an individual's imagined satisfaction or happiness in the three possible types of positions in those societies (a, b, c). In the utilitarian case, the numbers would represent actual utilities realized by the three types of persons.

In either case, the overall effect of each institutions can be represented as a triple, with a single number representing the consequences of the institution on each of the three types of persons (a, b, c).

- A. (5, 5, 5)
- B. (8, 7, 6)
- C. (4, 10, 10)
- D. (5, 2, 20)

As a point of departure, assume that the status quo is the egalitarian one, society A, and that only the three other types of society are possible, B, C, and D. Now imagine a constitutional convention among forward looking rational persons interested in improving their society through major reforms. If each persons knew exactly own their payoff (utility or wealth) in the society that emerges from institutions, each would have a different ranking of the possible reforms.

Individual "a" prefers institution B to all the others, including the status quo, person "b" prefers institution C, and person "c" prefers institution D. They all agree that reform is a good idea, but disagree completely about the best course of reform, because each is affected differently by the reforms that are possible.

A. Buchanan and the Veil of Uncertainty

From the Buchanan perspective, agreement is nonetheless possible. All three individuals will be uncertain about the long run effects of the reforms,

because the future is difficult--indeed nearly impossible--to predict accurately. Thus decisions about institutions are always shrouded by a veil of uncertainty. This, Buchanan argues, tends to promote consensus.

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

B. Rawls and the Veil of Ignorance

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

For Rawls, it is the agreement about principles of justice that emerge from behind the veil, rather than risk preferences, and these shared principles that ultimately generates the agreement. With a different justice principle, it is very likely that one of the other institutional arrangements would have been chosen.

Uncertainty in the outcomes themselves would affect the Buchanan approach when voters are risk averse, but would not affect the institution chosen under a maximin theory of distributive justice, because only the worst outcome matters under that principle. One always chooses the institution that maximizes the lowest payoff. For Buchanan, uncertainty generates consensus, but nonetheless tends to be undesirable.

D. Contrast with Utilitarian and Egalitarian Reasoning.

Under utilitarian reasoning, one selects among these institutions based on the sum of the utility payoffs, rather than expected payoffs or the worst

case scenario. If the above numbers are utilities, institution D is clearly the best: $27 > 24 > 21 > 15$. Although both the Rawlsian and Utilitarian frameworks tend to favor relatively equal outcomes when a wider array of institutional possibilities exist, they do not under the assumed limited range of alternative institutions used in this illustration. Note also the contrast between contractarian and utilitarian theories and egalitarian norms under which the status quo may be regarded to be the best (A), insofar as equal outcomes are always better than unequal ones. A is not the best institution under utilitarian or contractarian theories.

It is also possible that other factors than final outcomes affect the welfare of individuals in the societies of interest. For example, the processes that generate the outcomes under the four institutions may be more or less attractive, more or less compatible with private or civil virtue, tend to reinforce or undermine virtue, etc. Such effects would be included in the payoffs associated with each institution. Although voters evaluate the relative merits of institutions by imagining their own welfare, their welfare may not be fully determined by material welfare.¹⁹

VI. Conclusions: Ethics and the Assessment of Policies and Institutions

The twentieth century scholars reviewed in this chapter can all be regarded to be constitutional liberals in that they support commerce and democracy, although neither without reservations. With respects to markets, Pigou argues that the extent of commerce can be used as an indicator of aggregate utility or social welfare. Von Mises argues that the prosperity associated with the commercial society is itself a moral justification for both that society and the institutions that ground it. Rawls argues that markets tend to be efficient and so should play a role in the allocative processes of

any just society. Buchanan argues that the core processes of commerce--bargaining and contracting--are also core procedures in politics. He suggests, however, that only the policies that could have been unanimously agreed to can be accepted as good ones. In all their analyses, the commercial society that emerged in the late nineteenth and early twentieth centuries to be the model against which all others are judged--rather than the pre-capitalist society with its family-based privileges and formal class structure.

The correlation between what Pigou called the national dividend and aggregate utility was broadly accepted by economists and policy makers in the West for most of the twentieth century. The higher national income, the greater the average person's ability for increasing his or her material welfare. This association allowed alternative national policies to be compared with a single measurable index, rather than an imaginary aggregate of happiness. Such policies naturally tend to support commerce, because the extent of commerce is used to evaluate alternative political and economic systems.²⁰

The new contractarians challenged the validity such Pigou's various aggregate measures of welfare on several grounds. However, they normally agree that individuals generally prefer more to less wealth and so are inclined to favor reforms that increase average wealth or risk-adjusted average wealth. For contractarians, the extent of commerce is not used as a norm, but embedded in a model of human choice that implies that more material comfort is better than less, other things being equal.

Under both normative theories, commerce is a means to an end rather than an ultimate end. Nonetheless, both agree that a system that increases material comforts and amusements tends to increase eudaimonia, utility, satisfaction, or simply produce preferable lives. On the other hand, both

¹⁹ The illustration also illustrates a commonplace problem with using majority rule to choose income distributions, one emphasized in Buchanan and Congleton (1998). There is no stable majoritarian (Condorcet) winner if votes are cast on the basis of personal utility levels. C is preferred by two voters over B. D is preferred by two voters over C. And, B is preferred by two voters over D. Each possibility loses to another. Escape requires an internalized ethical principle or theory of distributive justice by at least one or two of the voters.

²⁰ Happiness indices were constructed late in the twentieth century based on survey evidence and were employed by a few researchers. See for example, Frey and Stutzer (2010).

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theories regards externality and public goods problems to be important, and raise questions about the distribution of income associated with markets.

That consequences are important for both utilitarian and contractarian normative theories made social science increasingly central to their conclusions. When similar norms are used, differences in conclusions reflect differences in the predicted consequences of an action, policy or institution. Differences in economic theories, for example, explain most of the differences between Pigou and von Mises.

The next two chapters provide overviews how neoclassical economics in combination with welfare economics or contractarianism have been used to identify potential problems with commerce and democratic politics. Chapter 10 uses welfare economics to evaluate market settings in which sellers or buyers have monopoly power, the activities of interest produce externalities, or the services are non-excludable public goods. Mainstream economics implies that markets will not maximize aggregate utility in such cases (even ignoring distributional issues). In such cases, markets are said “to fail.” Chapter 11 demonstrates that the same sorts of failures to maximize aggregate utility tend to be associated with democratic politics. Chapter 11 also examines tradeoffs between the use of markets and politics to allocate resources. Both are “imperfect” systems from the perspective of welfare economics, utilitarianism, and contractarian theories, as developed below, and the best combination should take account of their weaknesses as well as their strengths.

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