

The background of the entire image is a stylized American flag with horizontal stripes of red and yellow. In the upper center, there is a circular graphic composed of a dotted white line. Inside this circle, at the top, are three white stars of varying sizes. At the bottom center of the circle is a single white star. The text is written in white with a slight drop shadow, following the curve of the circle.

*American Federalism*

How Well Does It  
Support Liberty?

RICHARD E. WAGNER

# AMERICAN FEDERALISM



RICHARD E. WAGNER



**MERCATUS CENTER**

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**D**emocratic governments can be either national or federal in form. Within a national republic, a single government is the source of all taxation and regulation. That government might delegate some power to tax and regulate to lower units of government, but that delegation is the province of the higher government and can be reversed if that higher government so chooses. In contrast, within a federal republic people face at least two independent sources of taxation and regulation. For instance, US state and federal governments have the independent ability to tax and regulate their citizens.

Federalism is generally described as a pro-liberty form of government. Yet it is surely reasonable to wonder how two sources of political power within the same territory can be more favorable to liberty than one. It turns out that the pro-liberty quality of federalism is a possible but not a necessary feature. This essay explores this two-edged quality of federalism to discern more clearly the relationship between federalism and liberty.

All thinking about government and liberty must face a choice between two distinct starting points. One point of departure is to treat government as the source of individual rights, which gives government the ability to give or take rights at its discretion. The alternative point of departure treats individual rights as prior to government, with people creating government to *support* the rights of person and property.

This distinction is perhaps more analytical than historical, but it is historically meaningful all the same. In Europe before the

American founding, governments were absolutist in character. Government was the province of kings and other nobles, who stood apart from the society over which they governed. There existed traditionally established rights, duties, and obligations that governed relations among classes throughout the society, but governance was the business of the ruling class in any case. Merchants and peasants might hope for good government over bad, but what they got was not their business.

In contrast, the American experiment was founded on a rejection of these feudal trappings of power and status. Government was not a source of individual rights because government was rather something that people created to support and protect those rights. In this alternative scheme of thought, law, which governs relationships and interactions among the members of society, is prior to government. This is the scheme of thought that informed the American constitutional founding.

That founding is now more than two centuries behind us, and our constitutional framework has changed greatly, sometimes for the better and sometimes not when those changes are appraised from the perspective of individual liberty. This essay explains how the ability of the federalist form of government to preserve and protect individual liberty depends on some significant details concerning its constitutional structure.

Constitutional systems must and do change through time. Sometimes they change for the better, but not always. In the two centuries since our government's founding, some features of the American system have changed for the better, but other features have changed for the worse (from the perspective of liberty). A federal form of government can promote liberty, but it can also impair it. Which outcome is likely depends significantly though not exclusively on the constitutional structure within which governments operate. This essay explores the central features of a pro-liberty constitutional structure for a federal republic, and examines how the erosion of federal liberty that has been underway for around a century might be amended in a pro-liberty direction.

The American federal system was founded on the principle that competition among governments is the appropriate institutional complement to the individual liberty on which the nation was founded. Over the past century or so, however, the federal system has become increasingly monopolistic or collusive. A system of competitive federalism stands in opposition to a system of monopolistic federalism, in which political entities act in cartel-like fashion to promote the interests of their supporters over the interests of the rest of society. Within a system of monopolistic federalism, government becomes an instrument for expanding or contracting individual rights; this imports feudal principles into a constitutional system founded on the rejection of those principles.

This essay is presented in three parts. Part I presents some analytical background from the theory of public choice, which provides the framework for the rest of the essay. Public choice treats politics as a peculiar type of business. As a business, politics entails a systematic form of practice that involves rendering services and securing payment for those services. But it is a *peculiar* type of business, because politicians and bureaucrats can force people to consume their services, in contrast to ordinary businesses, which must attract willing customers. Part II applies public-choice principles to the economic organization of a national republic. This part uses public-choice principles to explore the ways and processes through which a national republic can weaken liberty in the pursuit of political gain. This part provides a point of departure for part III, which asks whether or under what conditions a federal republic might be better able to maintain liberty than a national republic. What comes out of this examination is recognition that, relative to a national government, a federal form of government can either support or impede liberty, depending on some significant institutional and constitutional features regarding the extent to which the federal system promotes competition or cartelization among governments.

## I. SOME RELEVANT ANALYTICAL PRINCIPLES FROM PUBLIC CHOICE

In exploring whether or the extent to which the federal form of government does significant work in securing liberty, it is necessary to adopt some suitable conceptual framework to facilitate exploration of the topic. I shall do so by using the economic theory of public choice. This theory provides a general conceptual framework for examining governments of all types. At its most general level, public-choice theory is grounded on the simple claim that people seek to be effective rather than ineffective in their activities. What renders an action effective varies with the institutional setting inside which that action occurs. Actions that are effective in bringing about commercial success, for instance, might not be effective in bringing about political success. In a similar manner, different constitutional arrangements will promote different types of political activity. Those activities, in turn, will have different implications for human liberty.

### A. Public-Choice Principles and the Practice of Government

Much of economic theory takes as its object of interest various aspects of commercial and industrial practice. Theorizing about commercial practice is different from practicing commerce, yet the two should be related. Economic theory abstracts from many significant details about commercial practice, yet a good theory should enable a commercial practitioner to see points of contact between his or her practical activities and the theorist's formulation, while also recognizing that the theorist is developing a lean and abstract portrait of a complex activity that cannot be

reduced to some simple recipe.<sup>1</sup> So the theorist's world is not the practitioner's world, and yet the two are connected: the theorist presents categories and relationships that the practitioner can recognize, even if much richness has been shed; the practitioner can look at the theorist's formulations and get a simplified view of some key facets of the practitioner's activities.

Public choice theory is a branch of economics that treats politics as a form of commercial activity, though a peculiar form. Politicians are businesspeople who earn their livelihoods through political practice. Other people invest in politicians through contributing both personal and financial support. These investors invest in politicians much as they do in commerce, and it is reasonable to think that some type of return is expected on that investment, although the return cannot accrue as dividends or capital gains because political practice does not operate with shares of ownership in political enterprises. In order to attract investors, politicians develop new programs and revise old programs in a continuing search to meet the competition, just as ordinary businesspeople do in ordinary commercial activity.

However, private commercial practitioners must attract business in open competition with other practitioners, and customers are able to give their business to whichever competitor they prefer. With respect to the political form of commercial practice, people cannot withhold patronage. Taxes will be collected, and politicians and their allies will be able to exercise a predominant voice over how those revenues will be spent (save to the extent that previous legislation has created obligations that today's politicians cannot avoid). In short, political practice has the same general pattern of activities as commercial and industrial practice:

1. This relationship between the abstraction embraced by the theorist and the complex situation faced by the practitioner is set forth brilliantly in Asik Radomysler, "Welfare Economics and Economic Policy," *Economica* 13 (August 1946): 190–204. In a luminous fashion, Radomysler distinguishes between useful and useless forms of abstraction in their connection (or lack thereof) between theory and practice. In particular, he thought that John Maynard Keynes's *General Theory* passed the connection test, while J. R. Hicks's *Value and Capital* failed it.

products are offered, offerings are accepted or rejected, payments are made, and people earn livelihoods and pursue careers. In all of these ways and many more, politics is a form of commercial activity. Yet politics operates without private property, without capital gains and losses, and without values being established for political enterprises. Politics is also a peculiar form of commercial practice.

The theory of public choice, which got underway in the 1960s, starts from the presumption that political organization and activity can be usefully understood from within an economic logic, once that logic has been amended to incorporate institutional differences between commercial and political practice. One major institutional difference is that commercial and industrial practice takes place largely within a framework of private property. In contrast, political practice takes place within an institutional framework grounded in common property as supported by various managerial regulations of the commons. In any case, the theory of public choice supplies the analytical framework within which this essay will explore the ability of the federal form of government to promote or restrict liberty.

## B. Federalism, Antifederalism, and the American Founding

The United States was founded in 1789 as a unique form of government, in which there was no single or unified source of political power in the land. This form of government was called federalism, though prior to 1789 federalism referred to something different.<sup>2</sup> Before 1789, “federalism” denoted confederations of governments. A confederation among governments leaves each of its members as the single source of political power within its own borders. The Articles of Confederation established after the War of Independence created just another in a long list of such confederations throughout history.

2. Martin Diamond, “The Federalist’s View of Federalism,” in *Essays in Federalism*, ed. George C. S. Benson (Claremont, CA: Institute for Studies in Federalism, 1961), 21–64.

In 1787, the Continental Congress established a convention to suggest revisions to the Articles of Confederation. What resulted instead was the creation of a new Constitution that established a new form of government. Between 1787 and the adoption of the Constitution in 1789, intense controversy arose over it. Supporters of the new Constitution succeeded in describing themselves as federalists, while describing those who wanted only to revise and not to replace the Articles of Confederation as antifederalists. This contrast of terms is ironic, in that it was the antifederalists who were the true federalists, according to how that term had been used for centuries. What the supporters of the Constitution called federalism was truly a new system of government, one that combined features of national and federal governments. In light of the strong opposition that existed throughout the land to a national form of government, the challenge faced by the authors of the *Federalist Papers* was to explain why the Constitution they were supporting was faithful to the old federalist principle while at the same time was capable of overcoming weaknesses that a significant number of people associated with the Articles of Confederation.

While the antifederalists were right in their complaint that they were the genuine federalists as that term was then understood, the supporters of the new Constitution carried the day. From that time to the present, the term “federalism” has denoted a system of government where no one entity is the sole source of political power within a nation. Instead, political power is divided between the central federal government and the state governments, each of which is able to independently tax and regulate within its borders. Under the Articles of Confederation, only a state government could act directly to tax and regulate individual citizens. The federal government could tax individual citizens only indirectly, by getting the states to collect taxes and submit the revenues to the federal

government.<sup>3</sup> Under the Constitution, by contrast, both federal and state governments could act directly to tax and regulate individual citizens. So the Constitution did create a national form of government, as the antifederalists claimed, but the national government was not the sole source of political power in the land, as the authors of the *Federalist Papers* explained.

Federalism is often characterized as a pro-liberty form of government, as contrasted to a unitary, national form of government, in which there exists a sole source of political power. Yet one might reasonably ask how replacing a single government that can tax and regulate you with two or more governments that can do so would be favorable to your liberty.<sup>4</sup> A simple question like this would seem to call for a simple answer. But indeed the correct answer is “it all depends.” The outcome depends on many considerations, and on how those different considerations play out in actual political practice. Under some institutional circumstances federalism might support liberty, while under other circumstances it might not. The task of this essay is to explore those different directions so as to gain a clearer understanding of when federalism is likely to promote liberty and when it is not. In any case, the American federal republic that was established in 1789

3. The adequacy of such revenues was a point of contention between federalists and antifederalists. Contributions by the states ranged between 26 and 77 percent of what the federal government requested by way of troops and between 0 and 64 percent by way of money. These data are taken from Jena Bednar, *The Robust Federation: Principles of Design* (Cambridge: Cambridge University Press, 2009), 64. In turn, Bednar’s data were compiled from data presented in Keith L. Dougherty, *Collective Action under the Articles of Confederation* (Cambridge: Cambridge University Press, 2001). The antifederalists claimed that in issuing requests for troops and money the federal government was not offering sufficient value for the proposed state contributions, as noted by Richard E. Wagner, “Anti-Federalists,” in *American Conservatism: An Encyclopedia*, ed. Bruce Frohnen, Jeremy Beer, and Jeffrey O. Nelson (Wilmington, DE: ISI Books, 2006), 42–44.

4. In this respect, James Buchanan explains that a single criminal firm is superior to a competitive system of criminal firms. Buchanan, “A Defense of Organized Crime,” in *The Economics of Crime and Punishment*, ed. Simon Rottenberg (Washington, DC: American Enterprise Institute, 1973). While the parallel between criminal firms and political entities is incomplete, it is useful to note all the same that there can be circumstances where competition is destructive and not beneficial.

not only was grounded in liberty but also reflected a deep economic sensibility that preceded the subsequent articulation of that sensibility through public-choice theory.<sup>5</sup>

### C. Good Government as a Cognitive Challenge

In the opening paragraph of the Federalist No. 1, Alexander Hamilton asked “whether societies of men are really capable or not of establishing good government from reflection and choice, or whether they are forever destined to depend for their political constitutions on accident and force.” Liberty requires more than an exercise of a person’s will, for it requires the exercise of mutually supporting wills when in many cases those wills may conflict. In this setting, public-choice principles can offer two types of knowledge regarding the properties of different constitutional arrangements. One type is negative knowledge of how some constitutional arrangements may undermine rather than support liberty. The other type is positive knowledge about the assembly of a constitutional framework that is capable of supporting liberty. In short, it may be relatively easy to state what constitutes goodness in government, and yet it can be difficult to achieve such goodness because the effort to achieve goodness runs afoul of the complexities of the task.

In 1945, Friedrich Hayek explained that a well-functioning economy required the assembly of knowledge that is available in its entirety to no one in the society.<sup>6</sup> In 1960, Frank Knight complemented Hayek’s work by explaining that democratic governments

5. James M. Buchanan and Gordon Tullock have explored the deep economic insight that informed the constitutional founding. Buchanan and Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962). Vincent Ostrom examines the economizing logic that was in play throughout the essays in the *Federalist Papers*. Ostrom, *The Political Theory of a Compound Republic*, 2nd ed. (Lincoln: University of Nebraska Press, 1987).

6. Friedrich A. Hayek, “The Use of Knowledge in Society,” *American Economic Review* 35, no. 4 (1945): 519–30.

face some truly knotted problems of assembling knowledge that are worsened by the ability of democratic processes to lead people to believe they know many things which they truly don't know; *those things*, Knight explained, typically do more damage than the things people know they don't know.<sup>7</sup>

One of the dominant myths of our age—one of those things that seems to be widely believed and yet is not true—is that liberty and democracy necessarily fit together in complementary fashion, much as a glove covers a hand to protect it against heat and cold. Democratic ideology thus commonly claims that democracy unavoidably works in the service of liberty and the common good. This claim more often than not reflects the triumph of wishful thinking over sober analysis. In contrast, the American constitutional republic was founded on sober analysis and not on wishful thinking. The task of sober analysis is to discipline thought so as to limit the ability of thought to damage practice through wishful thinking.

It is nice to think that public officials will use their powers of office to preserve and protect the rights of private property that are the basis for the creation of public offices. Yet the very creation of public offices creates positions of power that can take on autonomous or independent existence within society, as Carl Schmitt explained with particular cogency early in the 20th century.<sup>8</sup> Indeed, support for such principles as checks and balances and the separation of powers reflects recognition that democratic processes can operate autonomously to abridge rights of private property. The extent to which such abridgement might occur depends on the constitutional arrangements within which political power can be deployed. It is possible to imagine arrangements

7. Frank H. Knight, *Intelligence and Democratic Action* (Cambridge, MA: Harvard University Press, 1960).

8. Carl Schmitt, *The Concept of the Political* (1932; Chicago: University of Chicago Press, 1996). For a lucid examination of Schmitt's theory of the political, see Eckard Bolsinger, *The Autonomy of the Political: Carl Schmitt's and Lenin's Political Realism* (Westport, CT: Greenwood Press, 2001).

where that power might be pretty well neutered, but it is also possible to imagine arrangements where political power ranges widely throughout society.

Wishful thinking about the congruence of liberty and democracy might conflict with the realities of the organization of political power under various constitutional arrangements. A state of affairs that might be widely desired might nonetheless be impossible to achieve. Whenever wishful thinking comes into conflict with reality, we may be sure that wishful thinking will lose. Even worse, the conflict between desire and reality will often set in motion further reactions that will worsen the conflict. With respect to wishful thinking in economic matters, for instance, there seems to be strong public support for three conditions: (1) the exchange rate between the dollar and other currencies should be stable and not variable; (2) people should be free to spend their money in the US or abroad as they choose; and (3) monetary policy should promote economic stability.

These three conditions, however, are impossible to achieve, because they conflict with one another, as Robert Mundell and Marcus Fleming explained independently of each other in 1962.<sup>9</sup> Mundell and Fleming explained why governments cannot achieve all three values and that the effort to do so, to try to square the circle so to speak, will cause societal distress in one way or another. If a nation chooses a fixed exchange rate and allows free mobility of capital, it will have to abandon any control over the money supply. Should a nation instead assert control over the money supply, it will have to either to abandon its fixed exchange rate or impose controls on the mobility of capital. What is particularly noteworthy about the Mundell-Fleming formulation is that it illustrates how desire can run afoul of cognition. Efforts to achieve what can

9. Robert A. Mundell, "Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates," *Canadian Journal of Economic and Political Science* 29, no. 4 (1963): 475–85. Marcus J. Fleming, "Domestic Financial Policies under Fixed and Floating Exchange Rates," *IMF Staff Papers* 9, no. 3 (November 1962): 369–79.

not be achieved will necessarily fail, and that failure will bring unnecessary social disturbance; this is surely the domain of bad and not good government.

#### D. Piercing the Veil Called Government

It is linguistically convenient to describe corporate entities as undertaking actions of various types, even though we recognize that actions can only be undertaken by individuals (who may be connected in some fashion to a corporate entity). Hence we say that one company decided to buy another, rather than going through the verbal gymnastics that would be involved in stating more accurately that some set of persons acting on behalf of the corporate entity undertook this or that action. With respect to commercial corporations, moreover, no terrible inaccuracy is involved in attributing actions to corporate entities, because there is good reason to think that corporate actions entail something close to unanimity among participants due to the transferability of shares of ownership.<sup>10</sup> The transferability of ownership allows for the generation of share prices through transactions, which in turn fixes a market value for the enterprise. All participants in the corporate enterprise will generally be in the same position of preferring a larger over a smaller value for the corporation and its ownership shares.

There are exceptions to this proposition about unanimity, and these touch upon notions that are treated by the economic theory

10. Harry De Angelo, "Competition and Unanimity," *American Economic Review* 71, no. 1 (1981): 18–27; Lewis Makowski, "Competition and Unanimity Revisited," *American Economic Review* 73, no. 3 (1983): 329–39.

of agency.<sup>11</sup> The theory of agency recognizes that situations might exist where a corporate participant might seek personal advantage at the expense of corporate performance. That same theory also recognizes that private corporations have developed various schemes to restrict these agency costs. For instance, a foreman for a construction company could convert corporate wealth to personal wealth by taking home unused supplies and equipment. But corporations also develop various methods of monitoring and auditing inventory records to forestall such activity. Furthermore, corporations typically use compensation schemes involving incentives based on indicators of future corporate performance. There is no presumption that any of these devices reduces agency costs to zero, but there is good reason to believe they reduce those costs significantly from what they would otherwise have been.

Agency costs become particularly significant with governmental enterprises, rendering dubious any presumption that political entities will act the same way regardless of the identities of those who act in the name of the entity. Political entities do not operate under transferable ownership, which means that they will carry no share prices or corporate value. Therefore, it will not be possible to use compensation schemes that are calibrated to various measures of that value. Political enterprises will still employ various auditing and accounting techniques, but even there the extent of their employment is likely to be narrower, because the absence of measures of firm value gives executives less reason to be concerned with such devices.

Without transferable ownership, the general presumption that corporate participants agree in principle on the distinction between better and worse corporate performance weakens

11. For a brief sample of a large literature, see Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization," *American Economic Review* 62, no. 5 (1972): 777-95; William H. Meckling and Michael C. Jensen, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (1976): 305-60; and Eugene F. Fama, "Agency Problems and the Theory of the Firm," *Journal of Political Economy* 88, no 2 (1980): 288-307.

or even disappears. No longer can it be claimed that higher net income is superior to lower net income. Indeed, net income is not a meaningful indicator for political enterprises, so it cannot serve even as a focal point around which enterprise options can be examined.

For instance, suppose a hotel is considering converting some rooms into a day-care facility.<sup>12</sup> If the hotel were subject to private ownership, envisioning the deliberation process would be straightforward. Creating the facility would remove the revenue those rooms could generate. This reduction in revenue would provide a point of departure for asking whether there would be offsetting benefits that would warrant the change. With respect to guests, the facility might lower the hotel's vacancy rate because the hotel has become more attractive. With respect to employees, the facility might increase morale within the workforce, which might limit turnover and absenteeism, thereby raising efficiency. True, the people charged with making such a determination might still disagree among themselves over how to appraise the day-care facility. After all, any such appraisal involves speculation about different future scenarios, and it is impossible to know such outcomes with certainty in advance.

For a hotel operated as a political enterprise, however, the question of how the day-care facility might affect the value of the hotel is not even a meaningful object of speculation. One could, of course, always claim that the facility is in the public interest (or not, depending on the desire of the speaker). But public interest cannot be reduced to a measure, for it speaks to quality apart from quantity. Hence, it is impossible to state in advance what observations would affirm or deny the claim that creating the facility would be in the public interest. By contrast, for the private hotel, it is a simple matter to state observations that would affirm or deny the claim that the facility would increase the net value of the firm.

12. This example is taken from Richard E. Wagner, *Fiscal Sociology and the Theory of Public Finance* (Cheltenham, UK: Edward Elgar, 2007), 108–10.

In the government setting, there is more scope for participants to act on their personal preferences and to present those preferences as the “public interest.” Thus, the preferences that dominate political enterprises can vary with changes in controlling coalitions, in contrast to the situation in profit-seeking firms. When it comes to political enterprises and their activities, it is often necessary to pierce the organizational veil to uncover the interaction among interests that the veil hides.

#### E. Constitutional Rules Frame Political Outcomes

Collections of people can act as an entity only within some framework of rules that governs their interactions. Without such rules, a legislative assembly would be but a mob. Economic theory explains how such interaction can generate coherent patterns of activity when it occurs within a framework governed by private property. This coherence covers both interactions within individual firms and interactions between different firms. Public choice brings the same kind of analysis to bear on political processes. Just as private property shapes commercial interactions, constitutional rules shape political outcomes. The relationship between rules and outcomes can be open-ended, in that various outcomes might be possible from a particular set of rules. Nonetheless, political outcomes are to a considerable extent products of the rules that govern interaction among political participants. Recognition that rules both precede outcomes and shape outcomes has led public-choice theorists to place heavy analytical attention on the constitutional rules that frame political interaction.

To illustrate this idea in a way that will point to the themes that the remainder of this essay explores, we can compare two procedures that a unicameral legislature might use in adopting its budget. To further simplify the setting, assume that revenue is raised by a flat tax that is combined with some basic exemption. This assumption takes tax policy off the table and places the focus wholly on the determination of the budget. For additional

simplification, assume the legislature contains only five members (perhaps it is a town council). The budget contains two items: spending on parks and spending on police. The budgetary question concerns how much to spend on parks and police, with the total budget directly determining the tax rate.

One possible rule for making this choice is to adopt budgets for each item independently of the other item. Majority voting provides a simple parliamentary framework for doing this. One member of the legislature introduces a particular proposal, which another member might amend, and so on. The outcome of this procedure will be to select the proposal that is most highly preferred by the person with the median preference for the group. If such a motion is on the table, it will be impossible to find majority support for any alternative budget. This point is easy to see: Suppose the five members differ in their preferred budget size for parks. If someone proposes a budget either smaller or larger than the median preference, it will gain only two votes, either from the two who want a smaller budget or from the two who want a larger budget. Therefore, if anything other than the median budget is on the table, a majority will support an amendment to adopt the median budget. The median budget is the only one that will not be defeated by an alternative motion. Through this procedure, the town budget for each item will be the amount that is most highly desired by the person whose preference position is median within the group. The aggregate town budget will thus be the sum of spending on the two items, and the tax rate will be residually determined by the flat-tax restriction combined with the basic exemption.

An alternative rule for making the budgetary choice is to require approval of an omnibus budget bill. Whereas the previous rule generated an exact outcome, this rule leaves the final outcome open to bargaining and negotiation. There is a subset of budgetary outcomes that can emerge from this process. Each of those outcomes will receive the support of three of the five participants. Any set of three members constitutes a winning coalition,

but they will have to negotiate a budget that is acceptable to each of them. Furthermore, there are ten distinct three-person winning coalitions that can be formed from among five people, which further increases uncertainty in budgetary outcomes, in addition to increasing the difficulty of reaching a budgetary agreement.

The point of this brief discussion has not been to engage in an examination of possible budgetary rules but to illustrate one of the primary themes of public-choice analysis: the character of political outcomes is governed in large measure by the rules that govern interactions and relationships among those who participate in making such choices. While we speak of budgets as being choices of governments, what we really observe is budgets emerging through interaction among political participants as those interactions are guided by some more foundational set of rules—which can be described as being constitutional in character.<sup>13</sup>

## II. PUBLIC CHOICE, LIBERTY, AND NATIONAL REPUBLICS

Democracies can be divided between two general forms; one is national and the other is federal. Within the national form of a democracy, there is only one independently organized political entity within a nation. That entity might well create subdivisions, as when a state creates counties. But those counties owe their existence to the state and can be extinguished by the state, for counties have no independent constitutional existence. By contrast, in federal governments there are at least two levels of government that have independent constitutional existence. While federalism is often thought of as being a pro-liberty form of government, it is surely reasonable to wonder why liberty might be more secure

13. The centering of public-choice analysis on interaction and not on choice is set forth in Richard E. Wagner, “Choice versus Interaction in Public Choice: Discerning the Legacy of *The Calculus of Consent*,” in *Public Choice, Past and Present*, ed. Dwight R. Lee (New York: Springer, 2013), 65–79.

with two independent sources of political power than with a single source. This section uses public-choice theory to explore some problems of securing liberty within such a national republic.

#### A. Liberty and Democracy: An Uneasy Alliance?

It is a triumph of wishful thinking over sober analysis to think that liberty and democracy necessarily complement one another, at least so long as democracy is taken to mean majority rule. To be sure, the American founders were sober realists who did not engage in wishful thinking, so in turn they did not equate democracy with majority rule.<sup>14</sup> Indeed, they established numerous obstacles to the reduction of democratic processes to simple majority rule, many of which have since been weakened or even dismantled. For instance, the Constitution divided Congress into two chambers, the House and the Senate. Furthermore, different principles of selection were adopted for each chamber: whereas House seats were filled by direct election, Senate seats were filled by state legislatures. This arrangement created a diversity between the chambers that was reduced when the Seventeenth Amendment established the direct election of senators.

The original constitutional arrangement was based on the recognition that requiring concurrence between legislative bodies whose members were selected by different processes would more strongly reconcile liberty and democracy than when membership in those bodies was established by the same electoral process. These days, however, democracy is commonly thought to be synonymous with majority rule. But if democracy is synonymous with majority rule, it must be inconsistent with liberty. Put differently, if democracy is to be consistent with liberty, its processes and institutions must entail more than majority rule. While majority voting might come at the end of the line, so to speak, other sub-

14. Vincent Ostrom, *The Meaning of Democracy and the Vulnerability of Societies: A Response to Tocqueville's Challenge* (Ann Arbor: University of Michigan Press, 1997).

stantial obstacles must be surmounted before a vote can be taken if democracy and liberty are to be allies and not enemies.

So, how is it possible for democracy to conflict with liberty? Democracy is a scheme for governing human interaction. But so is liberty, which is a system of regulation grounded on private property. Private property is a regulatory system that accommodates the voluntary organization of social interaction. Economic theory explains how it happens that a society where individual action is largely organized through private property is able to generate coherent patterns of societal activity without there being any entity or organization to plan that pattern. As Leonard Read once explained, we take the use of pencils for granted and yet there is no person in society who can issue all of the orders extending over decades and centuries that would be necessary to produce pencils.<sup>15</sup> The owner of a stand of trees has no idea that some of the wood that will be harvested will be used to make pencils. Nor does the manufacturer of saw blades have any idea that some of those blades will be used to shape wood into housings for pencils. The central lesson of economic theory is that societies tend to generate coherent patterns of activity, not because there are some wise people who organize that activity, but because there is no one who even attempts such an impossible task.

Societies where people relate to one another within an institutional framework grounded in private property secure coordination among those people even though no one person can create that coordination. Each person in society knows a lot about his or her small area of expertise and knows very little about everything else, and yet an economic system based on private property is able

15. Leonard Read, *I, Pencil* (Irvington-on-Hudson: Foundation for Economic Education, 1958). For a textbook presentation of the scholarly framework behind Read's theme, see Paul Heyne, Peter J. Boettke, and David L. Prychitko, *The Economic Way of Thinking*, 12th ed. (Upper Saddle River, NJ: Prentice-Hall, 2010).

to achieve widespread coordination.<sup>16</sup> The central thrust of economic theory, in other words, is that societies grounded in private property and personal liberty are effective in generating coherent patterns of economic activity that promote flourishing societies.

For democracy to be rendered congruent with liberty, it would be necessary for collective action to receive unanimous support from those who contributed to its support. In contrast, simple majority voting, without auxiliary arrangements to restrict it, creates a conflict with liberty. Suppose a set of people think it would be nice to have a large plot of wetlands established as a bird sanctuary. In contrast, the owners of that land have plans to convert it into an amusement park. Within the liberal framework of private property and the market economy that grows around that framework, the supporters of the sanctuary could always buy that land from the present owners. Doing this would replace the amusement park with the bird sanctuary. However, the supporters of the sanctuary would have to use their own capital to do so.

Alternatively, the supporters of the sanctuary could resort to political action to create it. This course of action might be superior for the sanctuary supporters, because they could replace their own capital with capital attained from tax extractions imposed on other people. To stay with the example of majority voting, suppose a bare majority of the population would answer yes if asked the question, “Would you approve of converting this land into a bird sanctuary?” A motion could be put before a legislative assembly or before the population in a referendum, and if the motion were to pass, the bird sanctuary would be established.

What we have are two different social processes for deciding on the use of a plot of land. The market process operates through negotiation between owners of the land on the one hand and those who want to acquire use of that land on the other. In this case, the

16. This point is explained lucidly in Lee Cronk and Beth L. Leech, *Meeting at Grand Central: Understanding the Social and Evolutionary Roots of Cooperation* (Princeton, NJ: Princeton University Press, 2013).

land will tend to be used by those who can advance the highest bid to the owner. In contrast, the political process involves negotiation between those who desire to use the land and political agents who can take control of the land if a majority vote to do so passes. The reason why people who covet that land would resort to politics is that they can get the land more cheaply through politics than if they had to use the market and secure the permission of the owners.

To keep the illustration simple, suppose all members of the polity pay equal taxes. If so, using the political process allows proponents of the bird sanctuary to cut their costs in half (at least) as compared with having to buy the land directly from the owner. Once such a gambit is successful, the incentive to resort to politics to secure price reductions increases. This then restricts private property and diminishes liberty. Market transactions are voluntary exchanges among interested participants, while political impositions through majority rule confer benefits on some by imposing costs on others.

## B. Democracy as Faustian Bargain

Democratic government entails a form of Faustian bargain. The legend of Faust has captivated people for centuries, with many prominent literary figures creating stories that reflect the Faustian motif of bargaining with the Devil.<sup>17</sup> Christopher Marlowe did so late in the 16th century. Johann Wolfgang von Goethe did so early in the 19th century. The Nobel Prize-winning novelist Thomas Mann turned the Faustian legend into a novel in the 20th century. The Faustian motif has likewise appeared again

17. One cannot reasonably invoke the figure of the Devil without having the figure of God lurking nearby. Particularly noteworthy in this respect is Hans-Hermann Hoppe, *Democracy—the God that Failed: The Economics and Politics of Monarchy, Democracy, and Natural Order* (New Brunswick, NJ: Transaction Publishers, 2001). For a somewhat different contrast among regimes, see William A. Niskanen, *Autocratic, Democratic, and Optimal Government* (Cheltenham, UK: Edward Elgar, 2003).

and again in word and on film. Even Esau selling his birthright for some soup fits the Faustian motif. In all such instances of the story, a person sacrifices something of deep significance to gain a momentary advantage, often regretting the bargain after it has been made.

While the Faustian motif pertains to individuals and their bargains with the devil, Vincent Ostrom explains that the motif also pertains to democracy, though only to democracy.<sup>18</sup> It would not pertain to class-based systems, with their aristocrats and peasants, which were common to Europe at the time of the American constitutional founding. Under those systems, people were not regarded as having created their governments, so no type of bargain was involved. Government was rather the province of nobles who ruled as they chose. How they ruled was their business. The remainder of the population was born into a governmental arrangement that for them was a fact of life.

Different methods of exercising rulership could affect the well-being of ruling classes due to feedback from the extent of societal flourishing to the quality of life of the ruling classes themselves. This feedback is portrayed strikingly in Ambrogio Lorenzetti's fourteenth-century fresco "Allegory of Good and Bad Government," which covers three walls of the Palazzo Pubblico in Siena, Italy.<sup>19</sup> The distinction between good and bad in the "Allegory" is between justice, virtue, and flourishing on the one hand and vice, suffering, and misery on the other hand.

It was in recognition of this feedback from the level of societal flourishing to the well-being of ruling class that the Italian economist Amilcare Puviani fashioned the theory of fiscal illusion as a

18. Ostrom sets forth this theme in "Why Governments Fail: An Inquiry into the Use of Instruments of Evil to Do Good," in *Theory of Public Choice—II*, ed. James M. Buchanan and Robert D. Tollison (Ann Arbor: University of Michigan Press, 1984), 422–35. He elaborates that theme in "Faustian Bargains," *Constitutional Political Economy* 7, no. 4 (1996): 303–8.

19. See <http://www.wga.hu/frames-e.html?/html/1/lorenzet/ambrogio/governme/> for images of this fresco.

type of applied statecraft for absolute rulers. Puviani asked how the members of a ruling class could manage their affairs so as to live as well as they could. Puviani argued that they could do so by understating the costs of public activity and exaggerating the benefits.<sup>20</sup> For instance, Puviani advised that a ruler use many small taxes rather than a single large tax. He also recommended various promotional activities to magnify the perceived benefits of public activity. While the scholarly cogency of Puviani's formulation has been subject to continual controversy since Puviani first formulated it, what is particularly notable is that his scheme of thought was directed at a system where a ruling class was separate from those who were ruled. In this setting, the task of rulership was seen as one of creating an image that would soften the extractions the ruling class took from the remainder of the population.

While Puviani's framework directly pertains only to class-based societies where public offices are the province of some ruling class, the practices Puviani identified also find resonance in democratic politics.<sup>21</sup> Simply by creating a political apparatus, a country establishes positions of rulership that run contrary to the democratic ideology of a largely classless society. It is here where the Faustian bargain intrudes into the American constitutional founding. Within democracies of the American form, there is ideally no class of nobles who dispense largesse and who might be exhorted to use their superior standing to perform some public good. There is no superior standing aside from that which people might freely grant, and which they can just as freely take away.

20. Amilcare Puviani, *Teoria della Illusione Finanziaria* (Palermo: Sandon, 1903).

21. Puviani has not been translated into English, but he has been translated into German: *Die Illusionen in der öffentlichen Finanzwirtschaft* (Berlin: Dunker & Humblot, 1960). In the foreword to that translation, Gunter Schmölders explained that "over the last century Italian public finance has had an essentially political science character. The political character of fiscal activity stands always in the foreground. . . . This work [Puviani] is a typical product of Italian public finance . . . at the end of the 19th century . . . , in many places giving a good fit with reality." For an English summary of Puviani, see James M. Buchanan, *Public Finance in Democratic Process* (Chapel Hill: University of North Carolina Press, 1967), 126–43.

This is the classical form of liberal ideology that was present at the American founding. Yet the act of constituting a government creates positions and offices in society that resemble those of the aristocracies of old, and these positions create what Carl Schmitt described as autonomy for the political.<sup>22</sup>

Political officials are entrusted with instruments of power, which they are to use for public benefit. What public benefit means in this case is determined, not by those political officials, but by the remainder of society. Yet the possession of power will be used for harm as well as for good. Power always has this two-edged quality about it. The ability to force people to do things against their will inserts an evil instrument into society in the hope that the comparative weights of the good and evil that result will be mostly beneficial. Like the legend, the bargain is made because of a belief that the good the bargain will provide will exceed the harm. The bargain might work out this way. But it might not. The situation is particularly muddled because this bargain is not made by a single person with the devil but is made on behalf of many persons who may differ among themselves in how they appraise the bargain.

Government has the power to force people to do things they don't want to do, through both its budgetary and its regulatory powers.<sup>23</sup> While it is possible to advocate the insertion of political power into society as a means of promoting activities of general benefit, it is also widely recognized that the possession of power can be used for public harm. To be sure, no holder of political

22. Carl Schmitt was a liberal who thought that liberalism failed to wrestle sufficiently with the reality of power in politics, which in turn led to an emphasis on abolishing the political rather than finding a reasonable accommodation with what he thought could not be abolished in any case. Schmitt speaks for himself in Schmitt, *The Concept of the Political*. Two valuable studies of Schmitt are Paul Edward Gottfried, *Carl Schmitt: Politics and Theory* (New York: Greenwood Press, 1990); and Renato Cristi, *Carl Schmitt and Authoritarian Liberalism* (Cardiff: University of Wales Press, 1998).

23. James M. Buchanan, *The Limits of Liberty* (Chicago: University of Chicago Press, 1975).

power ever claims to be using it to wreak harm upon society. Every political official will claim that his or her programs and activities promote the public good. But how are other people to judge such claims? If there is no disagreement within the population at large, it would be reasonable to accept the claims of political officials. But short of such unanimity, we face a different and more difficult situation where conflicting beliefs are held at the same time within the population.

Consider the Fifth Amendment's "takings clause," concerning government confiscation of private property. This clause restricts the taking of private property by public entities by requiring that the taking serve a public purpose and that it be accompanied by just compensation.<sup>24</sup> Public purpose denotes something that would benefit society at large, as distinct from being advantageous to some people at the expense of others. The requirement that compensation be just, moreover, means that the owners of the taken property must be paid the market value of what was taken.

Within the American system of equality, in contrast to the feudal system, moreover, state action is ideally just an alternative form of multilateral exchange. Political action entails forced exchange as distinct from voluntary exchange. The American constitutional frameworks, however, placed the emphasis on exchange and not on the force behind it, for government actions were to reflect the consent of the governed.

This constitutional framework is not, however, easy to apply. For one thing, it would be unreasonable to require unanimity in order to fulfill the ideal of consent among the governed because of the high cost of working out exchanges among an entire population.<sup>25</sup> However, recognition of this costliness doesn't recommend that takings of private property be achieved through simple

24. Richard A. Epstein, *Takings: Private Property and the Power of Eminent Domain* (Cambridge, MA: Harvard University Press, 1985).

25. This theme is central to the constitutional analysis in Buchanan and Tullock, *The Calculus of Consent*.

majority voting. Majority voting can lead to excessive takings of private property, especially if compensation is inadequate when measured against market value. In order to see what this recognition does recommend, we must compare an ideal situation with our institutional reality. The requirement that a taking of private property must be for “public use” means that people must value that property more highly when it is put to public use than when it is put to private use. This requirement raises numerous and knotty questions about the types of knowledge by which such a judgment might be made. In short, such knowledge does not exist in any one place, any more than the knowledge of how to make a pencil from scratch is available in any one place.

Many instances of eminent domain involve the assembly of numerous parcels of land, all of which are necessary to the construction of some public project—for instance, widening a highway. In this case there is a government agency that claims that the proposed confiscation of property to widen a road will add more value through easing transit than it will take away by reducing the sizes of landowners’ lots. Now, it is always possible to imagine market-like transactions that would appraise these relative values: someone could propose to combine pieces of privately held land so as to widen a road. This could be done through market exchange, in which case there would be voluntary agreement among all participants to widen the road. Indeed, voluntary agreement is the only institutional arrangement under which it could be concluded that the conversion of the private lands into a wider roadway is of universal benefit. For instance, widening the road might require taking away a piece of each of 100 units of land, and each of these pieces might be valued by its owner at \$10,000. If the widened road were valued at more than \$1 million, the taking of the land at this price to widen the roadway would be valuable and agreeable to everyone.

The use of such illustrative calculations, however, simplifies unduly what is a complicated situation. For instance, there is no unambiguous way to determine the value to users of widening the

roadway. Someone might take a survey of drivers regarding how much they would be willing to pay for a widened road. There is, however, no good reason to think those responses would be truthful or accurate, particularly if the roadway will not be priced in any case. Most drivers along a road that sometimes experiences congestion would almost surely place positive value on a widened road if they thought there was any chance that a sufficiently high aggregate expression of value would lead to a widened roadway, even if they were not willing to pay their asserted value.

Furthermore, there is no good reason to think each landowner would make an accurate statement of the value of the losses of his land unless he were confronted with an actual offer to buy it. And even in this case there is the problem of strategic holdouts, which can arise if some potential sellers resist selling their land in the hope of achieving a higher price. Those individual parcels of land might be valued at \$10,000 each in their present use, while being valued at \$20,000 each when converted into an expanded roadway. While each landowner will gain at any price between \$10,000 and \$20,000, there are good reasons to think that such deals might not be so simple to arrange. For instance, suppose 90 of the 100 parcels have already been acquired at an average price of \$12,000. Without acquiring the final 10 parcels, the wider roadway won't be created and the 90 parcels will be worth only \$900,000 in the aggregate. Acquisition of those final 10 parcels will convert a strip of land worth \$900,000 into a lane of road worth \$2 million. This situation means those final 10 parcels are worth, on average, \$110,000 each, and each of those 10 owners can thus hold out for a price much higher than \$10,000, which illustrates the problem of the strategic holdout.

To point to the possibility of a strategic holdout does not, however, ipso facto warrant any claim that a proposed taking of property genuinely reflects the voluntaristic spirit of the Fifth Amendment's limitation on the taking of private property. It's quite possible that a proposed taking of property could secure majority support even though it would fail the voluntaristic test.

For instance, the prime support for a widened roadway might come from some trucking firms that would like to reduce the delays they face—only not enough to be willing to bear the expense of widening the road themselves. Most users of the road might place little to no value on the widened roadway. Yet those truckers might be significant supporters of those politicians who are in a position to recommend a decision about widening the road.

The Fifth Amendment illustrates sharply that the American Constitution sought to restrict majority rule, thereby expanding the scope for liberty. The Faustian bargain recognizes both that there might be good public purposes served by taking private property and that unrestrained legislative majorities would do this freely to secure price reductions for supporters of those confiscations, constricting liberty in the process. It is impossible to secure perfection in this situation. Simply to tell a legislative majority to take private property only when doing so serves a good public purpose will not do, because no legislative majority would ever assert that it is doing anything else. The ancient principle at work here is that people cannot be judges in their own cause, for those people will almost invariably see their causes as just. To promote liberty within a democratic system requires constitutional arrangements whereby legislative majorities can be overturned if they cannot secure concurrence from such differently constituted bodies as courts.

### C. Knut Wicksell's Effort to Reconcile Liberty and National Democracy

In 1896, the Swedish economist Knut Wicksell set forth a constitutional arrangement that he thought would reconcile democracy and liberty reasonably well within the Swedish context of

his time.<sup>26</sup> While we may doubt that Wicksell succeeded in doing so, his work has exerted substantial influence within public choice and constitutional political economy all the same, so it is worth some consideration. Wicksell's focus was on how to reconcile liberty and democracy as different societal frameworks for organizing economic activity, and on how to do this within a Swedish framework of national democracy.

Wicksell presumed that Swedish society could be reasonably represented in miniature through a parliamentary assembly made up of candidates from several different parties, with elections conducted under the rule of proportional representation. With proportional representation, if the number of parties is sufficiently large, it is reasonable to think that a parliamentary assembly could be selected that would be pretty much a miniature version of the larger society. Sweden was a monarchy at that time, and Wicksell placed the monarch as the head of the executive branch. The king would make his living by selling services to parliament. The more successful he was at doing this, the higher would be his earnings, for the monarch was effectively a businessperson.

While the monarch would make his livelihood by supplying services that parliament bought, there was limited scope for majority coalitions to act in the name of parliament and shift a good part of the cost onto the rest of society. Parliament could not operate by majority rule. In Wicksell's pure scheme, parliamentary decisions required unanimous consent. Within this setting, private property and democracy were congruent, for democracy was itself a reflection of the use of private property and was not some alternative to

26. Knut Wicksell, *Finanztheoretische Untersuchungen* (Jena: Gustav Fischer, 1896). An English translation of the second of Wicksell's three essays is "A New Principle of Just Taxation," in *Classics in the Theory of Public Finance*, ed. R. A. Musgrave and A. T. Peacock (London: Macmillan, 1958). Wicksell's effort to render congruent liberalism and democracy was central to the constitutional analysis presented in Buchanan and Tullock, *The Calculus of Consent*. I explore the relation between the untranslated parts of Wicksell's 1896 book and *The Calculus of Consent* in Wagner, "The Calculus of Consent: A Wicksellian Retrospective," *Public Choice* 56, no. 2 (1988): 153–66.

private property. Yet Wicksell also retreated modestly from unanimity by recognizing the pragmatic difficulties of truly securing unanimity in political settings. Hence, Wicksell voiced pragmatic support for requiring more than majority approval but less than unanimity, suggesting by way of illustration something between three-quarters and seven-eighths of the members of parliament.

Within this commercial mode of parliamentary operation, budgeting would proceed differently than it does within modern national democracies. There would be no budgetary process as such, characterized by independent procedures for raising revenue and deciding upon appropriations. Instead, budgeting would operate on the earmarking principle writ large. For instance, the king might propose several programs for road construction in different regions. Those proposals would be accompanied by proposals for covering the costs of the projects. The members of parliament could negotiate with the king and his staff until an agreement was reached among the required number of members of parliament. All budgetary matters would have this transactional quality, which would put government on something approaching a contractual basis.<sup>27</sup>

The Wicksellian scheme takes as given a national government along with recognition that majority voting allows winning coalitions to shift costs onto members of losing coalitions. Losing minorities thus subsidize winning majorities, with governmental programs expanding in the process. Wicksell sought to soften the conflict between liberty and democracy by organizing interaction between king and parliament in a commercial fashion. The commercial character of that interaction, moreover, was reinforced by the high degree of consensus required for parliamentary approval as well as by the multiparty system.

The American system at both federal and state levels is quite divergent from what Wicksell proposed for Sweden. The chief

27. It would only approach and not reach a contractual basis, because something less than unanimity would be required, which gives some scope for people to be forced to pay for services they do not value.

executives of the US states and the federal government are elected, and they work for salaries (and perks), in contrast to Wicksell's Swedish king, who would live off net income earned from the operation of public enterprises under his control. American political management thus occurs in more of a bureaucratic mode, in contrast to the commercial mode of Wicksell's Sweden. Within American electoral systems, with their single-member constituencies, there is no way that a legislative assembly could begin to approach a miniature representation of the society at large and to reflect the same voluntaristic qualities of societal governance through private property.

Yet the American founders clearly thought that the political system they were establishing would achieve such voluntaristic qualities. They expected to attain a similar outcome through a different institutional framework—one that divided and separated powers and then required concurrence among the holders of those pieces of power before government could act.

Now, we may doubt that the Wicksellian framework would truly eliminate the conflict between liberty and democracy, even if we might think that it would reduce that conflict. If the realm of the political possesses autonomy in society, it will be impossible truly to reduce politics to economics, to morality, or to law. Exceptional circumstances and conditions will always arise that will call for unprecedented action. This was Carl Schmitt's central theme. It is surely more reasonable to think of power as being limited or restricted than of being abolished. It's like living with a wild beast that cannot be domesticated: some ways of living with it might be better than others, but it will always be a wild beast all the same.

#### D. Rent Seeking, Rent Extraction, and the Democratic Erosion of Liberty

Federal budgetary powers at the time of the American constitutional founding were strictly limited both by the uniformity clause with respect to taxation and by the general-welfare clause

with respect to appropriation. That revenue would be raised in a uniform manner and that appropriations would be for the general welfare as distinct from the welfare of particular individuals attests to the founding constitutional vision that democracy should be rendered congruent with private property. This pair of constitutional requirements supports a framework of non-discriminatory democracy, which would have much the same effect as Wicksell's suggestion for unanimity.<sup>28</sup> While individual members of Congress would always be free to play Santa Claus with their own private capital, they could not do so in their capacities as members of Congress. In his masterful treatment of how Congress eventually did come to play Santa Claus without any change in express constitutional language, Charles Warren describes a century-long process that began with a constitutional bar to appropriating for the interests of particular people and ended in the 1930s with the recognition that the general welfare is whatever Congress declares it to be.<sup>29</sup>

The contemporary theories of rent seeking and rent extraction illustrate how political processes have become more enemies than protectors of liberty. Rent seeking and rent extraction both refer to politics being used as a process of taking and redistributing property rights—in contrast to the presumption on which the American constitutional system was founded, that the point

28. This is recognized in William H. Hutt, "Unanimity versus Non-discrimination (as Criteria for Constitutional Validity)," in *Individual Freedom: Selected Essays of William H. Hutt*, ed. Steve Pejovich and David Klingaman (Westport, CT: Greenwood Press, 1975), 14–33. Hutt's theme is amplified in James M. Buchanan and Roger D. Congleton, *Politics by Principle, Not Interest: Toward Nondiscriminatory Democracy* (Cambridge: Cambridge University Press, 1998).

29. Charles Warren, *Congress as Santa Claus: National Donations and the General Welfare Clause of the Constitution* (Charlottesville, VA: Michie, 1932). For a reconsideration of Warren's examination in light of an effort to treat constitutions from a positive rather than a normative orientation, see Petrik Runst and Richard E. Wagner, "Choice, Emergence, and Constitutional Process: A Framework for Positive Analysis," *Journal of Institutional Economics* 7, no. 1 (2011): 131–45.

of government is to preserve and protect property rights.<sup>30</sup> The prime difference between the two theoretical formulations is in the passive or active character of politicians. With rent seeking, passive politicians are besieged by people seeking favors, with those favors requiring the placement of restrictions on other people. With rent extraction, politicians become active pushers in extracting rents, in many cases by announcing an intention to sponsor legislation that can be withdrawn when the target convinces the legislative sponsor to do so. This is politics as extortion.

It is common to think that majority rule means that the basic division between winners and losers in any instance is on the order of 51–49. This is the world of the majority faction. But there is plenty of scope for minority factions to secure political domination as well. In these situations, a few people reap large gains while many people bear small losses. What allows such a situation to persist is the power of faction in conjunction with the existence of minimal thresholds of cost below which increases in cost are not noticed.<sup>31</sup> If we assume in a society of 1,000 people that individual citizens are equally likely to vote for or against a motion, a faction of 50 people will be able to get its way about 80 percent of the time. This is because at least 501 of the remaining 950 people would have to vote against the motion, and this has only about a 20 percent change of happening. Should that faction contain 75 people, it would win about 99 percent of the time.<sup>32</sup>

Mancur Olson explained that there is a fundamental logic of collective action that leads to the widespread success of minority

30. The concept of rent seeking was developed by Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft," *Economic Inquiry* 5, no. 3 (1967): 224–32; and is surveyed in Robert D. Tollison, "Rent Seeking: A Survey," *Kyklos* 35, no. 4 (1982): 575–602. Rent extraction is examined in Fred McChesney, *Money for Nothing: Politicians, Rent Extraction, and Political Extortion* (Cambridge, MA: Harvard University Press, 1997).

31. On the limited ability of people to discern small differences, see Gary A. Miller, "The Magical Number Seven, Plus or Minus Two," *Psychological Review* 63, no. 2 (1956): 81–97.

32. Robert Rogowski, *Rational Legitimacy: A Theory of Political Support* (Princeton, NJ: Princeton University Press, 1974), 77–142.

factions within democratic processes.<sup>33</sup> Olson's central theme can be expressed by the claim that intensity dominates lassitude in politics. A small number of people who can reap large gains through political action will often dominate a large number of people who each would suffer small losses, even if the aggregate amount of the losses far exceeds the amount of the gains. For instance, a particular legislative restriction on market exchange might damage 10 million people in a state by \$10 each. Most likely, those people wouldn't even be aware of that restriction because its small effect would allow it to escape people's notice. But suppose they were aware of it. One way they might register their opposition would be to write a letter to a legislative representative. We might imagine that writing that letter would require an hour. We can then also reasonably imagine that people who value their time at more than \$10 per hour would be unlikely to trouble themselves to write that letter. Hence, few of those 10 million people would be likely to register their opposition.

In contrast, that market restriction might be worth \$100 million collectively to the 10 parties who would gain from it. A gain of \$10 million each for those 10 people will inspire their collective action to secure that gain, while a loss of \$10 each for 10 million people will not inspire *their* collective action to prevent that loss. Democratic processes have strong tendencies to support minority factions unless those processes are offset by other constitutional measures that restrict the ability of legislative majorities to control political outcomes.

33. Mancur Olson, *The Logic of Collective Action* (Cambridge, MA: Harvard University Press, 1965). Olson extended his analysis of democracy, faction, and liberty in *Power and Prosperity* (New York: Basic Books, 2000).

## E. Democracy, Oligarchy, and the Scale of Political Entities

With respect to the scale of governance, the United States at the time of its founding was similar in scale to Switzerland today. At the time of its constitutional founding, the United States contained 13 states and a population of about 3.5 million. Today's Switzerland contains 26 cantons and a population of nearly 8 million. In comparison, the United States today contains 50 states and a population of around 320 million. Switzerland today has about 285,000 residents per canton on average, which is similar to the 270,000 residents per state at the time of the American constitutional founding. Now, however, American states average about 6.4 million residents. To achieve a scale of state governance similar to Switzerland today or to the United States when it was founded, something on the order of 1,200 states would be required. No one has proposed any such explosion in the number of states and it is hard to imagine that anyone would support such a thing. Yet this matter of scale raises significant issues regarding the relationship between democracy and liberty.

There is a significant difference between relationships that are scalable and those that are not, and which instead are what are called scale-free.<sup>34</sup> For the most part, economists work with models that are scalable. This means that the difference between a small and a large firm is a matter of multiplication and little else. A firm with 1,000 employees is just a firm with 100 employees multiplied by 10. If this presumption of scalability could be extended to politics, a state with 10 million people would be equivalent to a city of 100,000 multiplied by 100, or to a town of 10,000 multiplied by 1,000.

There is good reason for economists to suppose that commercial relationships are reasonably scalable. The market for fresh eggs, for instance, will operate in much the same manner no matter whether that market serves a thousand, a million, or a billion

34. The significance of this distinction is explored in Albert-Laszlo Barabási, *Linked: The New Science of Networks* (Cambridge, MA: Perseus, 2002).

people. With increases in the number of people being served, we would expect to find changes in such things as patterns of wholesaling, retailing, and distribution, as well as increases in the number of market participants. The division of labor does, after all, vary with the extent of the market, as Adam Smith explained at the time of the American Revolution.<sup>35</sup>

All the same, we would not expect changes in scale to affect basic propositions about how free and open competition tends to secure the full exploitation of potential gains from trade. It is private property that creates scalability in economic relationships. By becoming larger, a market-based entity might find increasing difficulty in managing its operations, in which case competition from smaller firms will reduce the size of the overly large firm. In other words, open competition tends to generate firms of efficient scale. At base, commercial relationships must reflect mutual attraction among participants, and this necessity of mutual attraction, which is a quality of private property, renders actual market relationships scalable.

This scalability does not pertain to political entities, because political entities do not face open competition. While political entities do sometimes operate with mutual attraction, they also employ compulsion, which allows scale to expand beyond what free competition would allow. For instance, a town of 10,000 might be governed by a town council of 10 people, each of whom would represent 1,000 people. This would represent a relatively personal scale of governance. Members of the council could plausibly know something about many of the people they represent and would often come across them while moving through such daily activities as jogging through a park or shopping in a supermarket. Beyond this, much council business could be conducted informally, even if the council also operates with regularly scheduled meetings.

35. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776; New York: Modern Library, 1936), 17–21.

It is not plausible to say that a city with 1 million people is just a town of 10,000 multiplied by 100. If the city council still contains 10 members, each member will now represent 100,000 people. It is impossible for someone to know much if anything about 100,000 people. What little that can be known, moreover, will be reducible to census-type forms and aggregated in some fashion. Only a subset of citizens will have direct access to council members, and the pattern of this access will be systematic and not random: power law distributions will dominate random distributions, reflecting concentrations of power. Access to political networks will be the province of people who represent significant interest groups within the city. The same democratic form will reside on the surface, but that superficial view will conceal oligarchic modes of operation.<sup>36</sup>

Alternatively, the city council could be increased to 1,000 members. This would maintain the original scale in which each member represented 1,000 people. In this case, the relationship between population and council size would be scalable; however, the relationship among council members would not be scalable. With a council of 1,000 members, most council members will not even know one another other than as nodding acquaintances. The council will operate with formal rules of procedure, and those rules will include limitations on who can address the council and for how long they can do so.

In this respect, Vincent Ostrom has explained how democratic oligarchy is a natural tendency of a simple or non-federal republic, the avoidance of which requires some polycentric arrangement of republics (if, indeed, oligarchy can be avoided at all, a proposition that Carl Schmitt would probably have denied in his treatment of the autonomy of the political).<sup>37</sup> With respect to simple republics

36. Robert Michels, *Political Parties: A Sociological Study of the Oligarchical Tendencies of Modern Democracy* (New York: Collier Books, 1962); Bertrand de Jouvenal, "The Chairman's Problem," *American Political Science Review* 55, no. 2 (1961): 368–72.

37. Vincent Ostrom, *The Political Theory of a Compound Republic*, 2nd ed. (Lincoln: University of Nebraska Press, 1987); Ostrom, *Meaning of Democracy*; Schmitt, *Concept of the Political*.

that operate with majority rule, public-choice principles explain that democracy is more compatible with liberty in smaller rather than larger scales of government. Increases in the scale of governance bring oligarchic characteristics, including domination by entrenched interest groups and an electoral process characterized more by the continuing reelection of incumbents than by competition among political parties. Competition between parties there is, to be sure, but even more notable is the low rate of defeat of incumbents seeking reelection. For large republics, federal or compound republics offer a path that entails compatibility between democracy and liberty, though that path can be hard to find and difficult to follow, as part III explains.

### III. PUBLIC CHOICE, LIBERTY, AND FEDERAL REPUBLICS

A federal republic differs from a national republic by virtue of a type of fragmentation of power between two levels of government. In the United States, both the federal government and the states have independent constitutional authority to tax, spend, and regulate pretty much as they choose, save for constitutional provisions regarding such matters as preventing states from imposing tariffs on products produced in other states. It is conceivable that a federal republic can secure liberty more effectively than a national republic, provided that governments act as independent units. Yet there is good reason to think they do not truly act independently of one another, which in turn leads to ambiguity with respect to the impact of federalism on liberty.

## A. Federalism as Decentralized Government: A Common Misconception

Federalism is often described as representing a decentralized organization of government.<sup>38</sup> This common description is not wrong, but it is misleading.<sup>39</sup> Decentralization describes the extent to which responsibility for budgetary and regulatory activity resides in a nation's capital relative to such responsibility being exercised in what might be called hinterland jurisdictions. Many unitary republics operate with extensive decentralization.<sup>40</sup> While federal republics also entail decentralization, it is possible for unitary republics to be more decentralized than federal republics. Decentralization and federalism refer to distinct political frameworks with different animating ideas about the source of political power. There may be cases where both forms yield similar observations about the degree to which responsibility on budgetary and regulatory matters resides with a central government rather than other governments within a nation, and yet these two types of democracy rest on different political presuppositions all the same.

For a unitary state, the situs of political power is the nation's capital. There might be constitutional language to the effect that sovereignty rests with the people, with political officials being merely reflectors of that sovereignty. But there is no alternative source of political power that can challenge national actions without adopting a stance of rebellion. The constitution may recognize some separation of powers among governmental entities, but the

38. This point is illustrated by the widely cited Wallace E. Oates, *Fiscal Federalism* (New York: Harcourt Brace, 1972), which is still the standard reference work that economists seem to use when referring to federalism. For some updating of the themes presented there, see Wallace E. Oates, "An Essay on Fiscal Federalism," *Journal of Economic Literature* 37, no. 3 (1999): 1120–49.

39. The error of equating federalism with decentralization is examined in Giuseppe Eusepi and Richard E. Wagner, "Polycentric Polity: Genuine vs. Spurious Federalism," *Review of Law and Economics* 6, no. 3 (2010): 329–45.

40. The extent of decentralization in unitary and federal republics can be compared directly in Vito Tanzi, *Government versus Markets: The Changing Economic Role of the State* (Cambridge: Cambridge University Press, 2011).

relevant governmental entity is unified in any case and so should in the end speak with one voice.

It is different with a federal republic, in which there is no presumption that government is constituted through a single entity that should speak with a common voice even if it is organized through a separation of powers. The relevant standard by which to categorize democratic forms of government is not whether they are centralized or decentralized but whether they follow a monocentric or polycentric organizational arrangement.<sup>41</sup> A monocentric arrangement is illustrated by standard tables of organization, which show a head of an organization and various levels of subordination below the head. For instance, an organization might have four divisions, with the heads of those divisions reporting to the head of the organization. Each of those divisions might in turn have four subdivisions, with the head of each subdivision reporting to the head of the relevant division. Each of the sixteen subdivisions at the bottom of the organization might have substantial autonomy in their daily operations, and yet all subdivisions would be subject to control by the head of the organization.

Thus, while political power is lodged at the top in a monocentric polity, that polity might employ a good deal of decentralization of administrative and political responsibility all the same. American states, for instance, are organized in monocentric fashion and yet typically are highly decentralized. Each state is subdivided into

41. On polycentrism, see the still-valuable examination in Michael Polanyi, *The Logic of Liberty* (Chicago: University of Chicago Press, 1951). For a creative application of polycentrism to the economic organization of the Soviet Union, see Paul Craig Roberts, *Alienation and the Soviet Economy* (Albuquerque: University of New Mexico Press, 1971). Among contributors to the literature on federalism, Vincent Ostrom has been in the forefront of advancing polycentricity. In addition to some of Ostrom's previously cited works, see Vincent Ostrom, *The Meaning of American Federalism* (San Francisco: ICS Press, 1991). For an application of polycentric principles to the political organization of metropolitan areas, see Vincent Ostrom, Charles M. Tiebout, and Robert Warren, "The Organization of Government in Metropolitan Areas: A Theoretical Inquiry," *American Political Science Review* 55 (December 1961): 831–42; and Robert L. Bish and Vincent Ostrom, *Understanding Urban Government: Metropolitan Reform Reconsidered* (Washington, DC: American Enterprise Institute, 1973).

counties that collect taxes, hold elections for county offices, and provide various public services. In principle, a state can subdivide, merge, or otherwise change the boundaries of its counties. A state can also impose conditions on the operation of counties. The same general rules pertain to the organization of cities and towns within counties, as well as to the formation of special districts (which in some instances cut across county borders).<sup>42</sup> Within the borders of a state, governance is organized in a monocentric fashion. What holds for counties holds for cities, towns, and various special districts as well. All states have procedures by which subordinate governments can be established and through which boundaries can change. Those procedures, however, are the province of the state, and in principle a state can change those procedures as it chooses.

There are many reasons why a state might operate with a good deal of decentralization of governmental authority. Some of those reasons concern matters of administrative efficiency. A state that has 40 counties, for instance, could operate all its recreational facilities from the capitol, or it could leave the provision of recreational services to its individual counties, save perhaps for the provision of some relatively large recreational facilities by a state agency. When services are supplied closer to those who use them, it is generally possible for providers on the ground to get a better idea of how users value them.<sup>43</sup> For instance, a county might provide a lakeside park. To operate that park, it is necessary to make choices about such matters as how much space to devote to picnic facilities rather than to Frisbee golf. If such parks were operated as commercial enterprises, it would be possible to gauge

42. The qualifier “in principle” means that a state government might find it difficult or even impossible to act unilaterally on its counties because county officials have some ability to influence the conduct of state activities. With respect to *de jure* as distinct from *de facto* authority, however, county governments are subordinate to state governments.

43. Charles M. Tiebout initiated this line of inquiry among economists. See Tiebout, “The Pure Theory of Local Expenditures,” *Journal of Political Economy* 64 (1956): 416–24.

consumer demand by examining revenues collected from the different activities. But in the non-priced environments typical of county parks, relative demands for different types of activities cannot be gauged by revenues generated through admissions. The option that remains to gauge demands is estimation in some fashion by detached experts. Those experts who work at the point of service delivery will generally be able to make more accurate judgments about these kinds of matters than will experts who reside in the state capital.<sup>44</sup>

Furthermore, governance from the capital will require more levels of bureaucracy than will governance at the county level. A county may well have a supervisor over all parks in the county as well as supervisors for each of the parks. Whatever structure of bureaucracy that might exist within a county, centralization of that activity at the state level will involve additional levels of bureaucracy. For instance, in a state with forty parks, the state commissioner of parks might have five district supervisors, each of whom supervises eight counties. Thus state provision would entail four levels of bureaucracy, in contrast to the two levels that would exist when parks were provided by counties. In this regard, we should remember that the provision of recreational services takes place only on the ground level, so to speak. Aside from the ground level where services are actually provided, the other levels are mostly engaged in administration and not service provision, as Gordon Tullock explains with especial clarity.<sup>45</sup>

44. This theme has been developed with voluminous evidence in numerous studies produced by or sponsored by Vincent and Elinor Ostrom as part of the scholarly program in the Workshop in Political Theory and Policy Analysis at Indiana University. A good number of those works are collected in Michael D. McGinnis, ed., *Polycentricity and Local Public Economies* (Ann Arbor: University of Michigan Press, 1999). For a thorough examination of the research program of that workshop, see Paul D. Aligica and Peter J. Boettke, *Challenging Institutional Analysis and Development: The Bloomington School* (London: Routledge, 2007).

45. Gordon Tullock, *The Politics of Bureaucracy* (Washington, DC: Public Affairs Press, 1965).

In contrast to monocentric though decentralized governments like US states, a federal government is polycentric in character. While federalism resembles decentralization, it is more than decentralization. In this respect, Jena Bednar explains that “federation is more than divided authorities. It also requires independent wills and the power to exercise them.”<sup>46</sup> Within the spirit of a federal form of government, the federal government cannot impose its will on the lower levels of government that constitute the federation. In the American system, both the states and the federal government have independent constitutional standing. While there are many ways that states and the federal government can influence one another, the pattern of influence is reciprocal and not unilateral.

For instance, all states conduct educational activities, as do school districts within each of the states. The federal government influences in many ways the educational activities of those lower-level governments, but it cannot dictate policy to those governments while maintaining a spirit of federalism. Federalism requires multiple, state-based systems of education rather than a single, national system. In contrast, to create national standards is to replace polycentric principles with monocentric principles, thereby weakening federalism and liberty through an expansion in the reach of democratic oligarchy.

## B. An Idealized System of Independent States and Competitive Federalism

Just as economists have studied the properties of an economic system based on free and open competition, which is governed by an institutional framework centered on private property, so can one study the properties of a political system based on open competition among the political entities that reside within a federalist

46. Jena Bednar, *Robust Federation*, 9.

system.<sup>47</sup> Such a political system based on independent and competitive entities would be the political counterpart of an economic system based on private property.

As originally established, American federalism was based largely on open competition. The federal government possessed enclaves of monopoly, not least of which was the so-called supremacy clause, which asserted that federal legislation trumped state legislation in cases of conflict. The federal government also held a postal monopoly. And diplomacy and the prevention of invasion were its province as well. Yet such enclaves were few in number and generally were not topics of controversy. For the most part, the American political system was envisioned as one that carried the principles of free and open competition into the political organization of society.

Yet each state taken alone would be a national or unitary entity, and so would be susceptible to the problems of rent seeking and rent extraction. The majority principle of democracy would seem to conflict with the unanimity principle of private property, unless auxiliary constraints on democratic action are in place to limit the operation of the majority principle. Theories of rent seeking and rent extraction explain how political coalitions can seize gains by infringing on the liberties of other members of society. The structure of such coalitional activity invariably takes the form that some established set of enterprises is able to secure state-sponsored restrictions on competition, thereby securing cartel-like gains. This restriction on liberty is a latent quality of democratic government where majority rule is in conflict with private property and liberty of contract.

But states are not exactly like small, independent nations, for they are part of a federal system. Each state may be like a small nation in relation to other states, but each state is also a member of

47. On federalism as a system of competition among governments, see Thomas E. Dye, *American Federalism: Competition among Governments* (Lexington, MA: D. C. Heath, 1990); and Daphne A. Kenyon and John Kincaid, eds., *Competition among States and Local Governments* (Washington, DC: Urban Institute, 1991).

a federation, which brings challenges and opportunities into play that would not confront a single nation. The federal government has responsibility for maintaining free trade among the states, and to this effect could bring judicial remedies to bear against state-sponsored cartels that otherwise would restrict the openness of competition within individual states. In such a setting, we would have an illustration of how a federal system might operate to secure liberty and protect competition more effectively than would be possible within a national system.

To be sure, this illustration is incomplete because it shows only one side of a coin of possibilities. The other side would show federal sponsorship of cartels, examples of which exist in profusion. For instance, between its creation in 1938 and its elimination in 1984, the Civil Aeronautics Board did not allow a single new airline to carry passengers across state lines, despite the vast growth in air travel that occurred during this period. This is an example of using the federal government to sponsor a form of cartel federalism rather than competitive federalism.<sup>48</sup>

This situation also points to a significant constitutional asymmetry within the American system.<sup>49</sup> Citizens can challenge the constitutionality of state actions in a federal court. This ability fits with the principle that no man should be a judge in his own cause. In this instance, a state should not be able to issue a judgment in a case advanced against it, even if it is different offices of the state that are involved under the separation of powers. Judicial, legislative, and administrative authority may reside in independent offices, but such independence must always be incomplete, because all the offices are staffed through variations on the same

48. For a wide-ranging treatise on the ideal of competitive federalism in relation to the reality of cartel federalism, and how a restoration of competitive federalism might be approached, see Michael S. Greve, *The Upside-Down Constitution* (Cambridge, MA: Harvard University Press, 2012).

49. This asymmetry is explored in William A. Niskanen, "The Prospect for Liberal Democracy," in *Fiscal Responsibility in Constitutional Democracy*, ed. James M. Buchanan and Richard E. Wagner (Leiden: Martinus Nijhoff, 1978), 157–74.

electoral process. Hence, the ability of people to challenge state actions in federal courts makes constitutional sense.

What does not make similar constitutional sense is the requirement that challenges to the constitutionality of federal actions must be taken to federal and not to state courts. In such cases, the federal government will be a judge in its own cause. Short of a situation in which state courts could render judgment on federal actions to restore constitutional asymmetry, it is not clear whether federalism provides protections for liberty that go beyond what would be part of a national government or whether it simply shifts the locus for the supply of restrictions on liberty and competition to the federal government.

Judicial processes, however, are not the only source of protection against government infringements on liberty and competition. They might not even be the most significant source. Another source, and perhaps the dominant one, is competition among the states. A national system may entail considerable administrative decentralization and delegation of responsibilities, and yet the extent of competition among subdivisions will be governed by the central government. Within a system of competitive federalism, by contrast, officials of individual states will typically feel more intensely the need to be competitive than would lower-level officials in a national bureaucracy. This does not mean that competition will necessarily trump rent seeking among states within a federal system, for there can still be plenty of gain to politicians from supporting rent-seeking activities. However, genuine federalism does seem better able to accommodate competition than does a national government, due to the need for states to attract residents, which does not face a national government.

### C. Political Interaction and the Cartelization of Federalist Competition

In *The Sociology of Philosophies*, Randall Collins sets forth a model of scholarly competition that has the aim of sketching a framework

for the birth and death of schools of thought.<sup>50</sup> Collins's framework of scholarly competition entails scholars competing for what he called attention space. Scholars articulate ideas that they think or hope will prove attractive to other scholars. The ideas that are capable of being articulated are vastly in excess of the ability of scholars to follow all those ideas. In other words, a scholar's attention space is limited relative to the total stock of ideas to which attention could be paid. Hence, scholars must choose which ideas to follow and which to ignore. This situation of scarcity leads to the formation of schools of thought, where individual scholars tend to pay greatest attention to ideas from those schools with which they most closely associate while also giving some attention to contributions from closely competitive schools.

In some significant ways, political competition resembles scholarly competition. Politicians, like scholars, compete in a setting where attention space is limited. Just as it is impossible for a scholar to read everything all other scholars write, so it is impossible for people to pay attention to everything each politician does or says. Thus, politicians operate in a competitive world, just as do scholars. Politicians typically get their start in local politics, with some advancing to higher levels after success at those lower levels. To be sure, not all politicians follow a path from lower to higher levels, but most of them do. Those who don't typically have reputational bases outside of politics, and these bases commend them to influential members of their chosen political party.

It has often been noted that all politics is local politics. This simple observation conveys a deep truth about political competition and the difficulty, if not the impossibility, of maintaining independent action among political entities within a federal system. To a significant degree, electoral success is a matter of becoming familiar in a warm way to voters. An important ingredient in attaining

50. Randall Collins, *The Sociology of Philosophies: A Global Theory of Intellectual Change* (Cambridge: Harvard University Press, 1998).

such familiarity is to develop a reputation for addressing issues that your voters care about. Within the original constitutional framework, most of the matters of interest to voters stemmed from local and state levels of government. This isn't to deny the importance of the matters of war and peace that were the province of the federal government. It is only to say that those were not issues that people could do much about. In contrast, the condition of schools, roads, or parks were things of concern to many people and, perhaps more significantly, were issues that ordinary people might conceivably have an impact on.

When faced with this type of setting, what might an ambitious politician do? To gain access to limited attention space, a politician must be able to address issues of interest to the various audiences he or she faces. It seems plausible that an aspirant to federal office, in whichever chamber, could get better access to attention space if the topics that he addressed included matters of local interest. To do this, however, required an expansion in the agenda of topics covered by the federal government beyond what was constitutionally enumerated. Securing grants in aid from federal to state and local governments were one means of achieving this expansion. The Morrill Act that established land-grant universities, for instance, brought the federal government into education, even though, constitutionally, education was the province of states and of individual citizens.

The position of political parties surely reinforces the emergence and growth of cartel federalism. Political parties did not exist at the time of the constitutional founding, but within a few years they had made their presence felt. In the absence of parties, several candidates might stand for office, and those candidates would likely hold a variety of positions. When political parties appear, there is surely a narrowing of the options over which competition occurs. Indeed, this would be one of the primary consequences of the development of parties, particularly in the two-party system that tends to come about when only one can-

didate is elected per district, and which stands in contrast to the usual outcomes in systems of proportional representation.

In thinking of competition, people typically think of the competitors as acting independently of one another. Without parties, competition among candidates would reflect this independence. Political parties, however, act as collusive agents by creating coherence among candidates across different levels of elections. Within this context, a natural progression for politicians is to move from local to state offices and then perhaps to national offices. Electoral competition still takes place, but the diversity of opinion expressed through such elections is narrower than it would be without political parties. In other words, the combination of ambitious politicians and political parties that are vertically integrated across all levels of government creates a cartelizing or centralizing tendency due to the ordinary desire of politicians to advance to higher office.

#### D. Public Debt, Cartel Federalism, and Systemic Lying

If states were truly independent of one another and of the federal government, each state would face a hard budget constraint. This constraint would not prevent borrowing, but it would put state and local debt on a similar footing as personal and business debt. Creditors might still be willing to lend, but in doing so they would have to exercise due diligence, secure in the knowledge that insolvency would lead to default, at least at the state level. (It would be different for the federal government, because it could still create money to spend its way out of insolvency. While this inflationary policy may be a source of economic disturbance, it is nonetheless an option the federal government has that states do not.)

But today's US states do not in fact have hard budget constraints, because the states and the federal government are in a deeply entangled relationship. In some cases it is even impossible to recognize insolvency, or at least its source. State and federal budgets are no longer independent from one another. Instead, they

are deeply entangled where significant amounts of state spending now occur at the behest of the federal government. For instance, about 40 percent of government spending on Medicaid is done by the states, with the federal government covering the rest, though these percentages vary from state to state. Such entanglements among governments are promoted through all kinds of programs in which the federal government offers support for state projects, provided that the states conform to federal requirements. A state might be insolvent if it had to finance all the programs it agreed to support. But when the federal government funds some of those programs, that insolvency might be avoided from the perspective of the affected state, and yet a form of systemic insolvency can remain and hover over the future.

While it is often noted that the public debt of the federal government is now over \$17 trillion and rising, due to a budget deficit of around \$1 trillion, the actual insolvency of the federal government is far greater than that. The unfunded liabilities of the federal government, stemming especially from Social Security and Medicare, have been estimated to be on the order of \$100 trillion. Federal liabilities represented by public debt refer to explicit promises made to bondholders. Five times larger in magnitude are the liabilities that are inherent in the promises made through social security and Medicare that are not funded but which remain for the future to deal with. At base, the presence of these unfunded liabilities means that there is an inconsistency between two types of political promises. One type is the promises made to people in their capacities as beneficiaries (this is the type of promises politicians like to make). The other type is the promises made to people in their capacities as taxpayers, which describe the taxes each person must pay to make possible the fulfillment of those future commitments to beneficiaries. The extent of unfunded liabilities is a measure of the extent of what could be called systemic lying, that is, the extent to which the federal government makes expenditure promises that it cannot keep without breaking its current tax promises.

To use Michael Greve's image of the upside-down Constitution, the American constitutional framework has been turned upside down, and systemic lying is one feature of this inversed order.<sup>51</sup> As Greve explains, the original Constitution envisioned competition among governments, but the federal government has led the way in replacing competition with cartelization, thus turning the Constitution upside-down. Unfunded liabilities, along with the soft budget constraint that promotes the accumulation of public debt, have played a key role in transforming the American system of largely competitive federalism into a system of cartel federalism. A gigantic step toward the restoration of a system of competitive federalism could be taken simply by treating public promises in the same fashion as private promises. If public debt is created today, liability to repay that debt would also have to be assigned explicitly to private citizens today. Just as people might have private retirement accounts, so they could have private liability accounts for public debt. In this manner, public debt would be handled in the same manner as private debt.

Actually, this scheme of assigning personal liability for public debt at the time the debt is created is not too far divergent from the prevailing order in American fiscal history before the 1930s.<sup>52</sup> Prior to the 1930s, federal debt that was created during wars and depressions was reduced during normal times. While government did not assign personal liability to each citizen for debt retirement, it was very clear in political discourse that borrowing today would be accompanied by higher taxes tomorrow. There was a clear sense that increased spending today would be accompanied by increased taxation tomorrow to pay off that debt. This is no longer the case, as public debt has now become a normal rather than an unusual means for financing government.

51. Greve, *Upside-Down Constitution*.

52. This historical point is explained in James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977); and it is amplified and extended in Richard E. Wagner, *Wrestling with Tragedy on the Fiscal Commons*.

Assigning explicit liability for debt to taxpayers, with that liability passing on to estates when those taxpayers die, would surely weaken the ability of politicians to postpone dealing with difficult situations by making promises that they know cannot be kept. It would, in other words, place politicians on the same footing as ordinary citizens, which was one of the presumptions on which the American republic was founded.

## IN CLOSING

It has long been noted that eternal vigilance is the price of liberty. Good government is not a destination or a final resting point. It is a continual, never-ending process. There are two basic though complementary tasks involved in securing good government. One task involves the use of the moral imagination, and concerns the principles by which we are to live together. History and our imaginations can present us with many options in this respect. This essay starts from an affirmation of the values of liberal and open societies where human relationships are fashioned through interaction among equals as governed by the principles of private property and freedom of contract. Government is not the source of property rights, for law precedes government. Government is, rather, an arrangement for supporting and maintaining the liberal order of human interaction.

However, ideals can be realized only imperfectly in practice, of course, and the Faustian character of the bargain that government represents assures us that this will be the case. The second task is for us to undertake the cognitive work of relating our institutional arrangements to the types of practice that those arrangements promote or block. This task leads in several directions and generates a number of general associations. For instance, it is inconsistent to support both a free and open society and simple democracy, because democratic practice will undermine the values of the open society. It is, however, possible to maintain democratic polities in a federal form of governance, provided that that form

of governance operates according to polycentric and competitive principles and not hierarchical or collusive principles.

Most fundamentally, governance in a liberal order must be approached from the bottom up rather than from the top down. This bottom-up character was recognized in the Declaration of Independence's assertion that governments derive "their just powers from the consent of the governed." Governmental powers derive from individual rights, and not the other way around. This is the upright constitution and not the upside-down constitution. Democracy is a derivative value, with governance grounded in relationships of mutual respect among equals being primary, and with fragmented and overlapping civic association emerging out of the extension of those relationships. The actual institutional arrangements of governance must be conformable with those principles of value; otherwise, contrary practice will set in motion a process of regime drift whereby a competitive federalism becomes cartelized or monopolized.<sup>53</sup> Charles Warren portrayed a beautiful example of regime drift in his masterful little book *Congress as Santa Claus*.<sup>54</sup> There, Warren described how over a century the general-welfare clause of the Constitution was continually subjected to pressures within Congress for reinterpretation of its meaning. In consequence, a clause that originally was recognized as being a restriction on the ability of Congress to enact legislation unless it was reasonably of benefit to society at large came to entail the presumption that the general welfare was whatever Congress enacted through legislation. Yes, eternal vigilance is the price of liberty, for power always pushes its own expansion. Keeping power in check is a task that never ends and about which there is no guarantee of success.

53. Richard E. Wagner, "Retrospective Regime Drift within a Theory of Emergent Order," *Review of Austrian Economics* 19, no. 2 (2006): 113–23.

54. Charles Warren, *Congress as Santa Claus*.

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