

# CONSTRAINING THE TRANSFER SOCIETY: CONSTITUTIONAL AND MORAL DIMENSIONS

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## Introduction

The recent emphasis in the economics literature on transaction costs and contracting has provided economists with a much clearer understanding of the social coordination process in a market setting. Perhaps the most important conclusion to be drawn from this literature is that focusing solely on adjustments along the price and quantity margins does not capture how robust human action is. Market exchanges are often complex agreements between individuals, and involve principals hiring agents to carry out specific functions. These arrangements result in gains from trade (rents), the distribution of which must be specified through the contracts. Otherwise the rents would be always up for grabs until rights to them were defined and enforced through the contractual process. Hence there are benefits associated with resources devoted to contract specification but obviously there also are costs. Given these costs, it is in the interest of entrepreneurs to conserve on transaction or contracting costs. Self-enforcing contracts (Klein and Leffler 1981), residual claimancy (Alchian and Demsetz 1972), postcontractual opportunism (Klein, Crawford, and Alchian 1978), and wealth held hostage (Williamson 1983) are all examples of the insights into the contractual process that have come out of this way of thinking.

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By adapting the transaction cost/contracting tools to the area of social contracting, we can develop similar insights into the nature of government. Just as there are agents and principals who contract with one another in the marketplace, the political process has citizens (principals) who grant the power of coercion to an agency (government) in return for the provision of public sector goods and services. Out of this framework comes a positive theory of government based on transaction costs and contracting. This principal-agent framework suggests that constitutional and moral (ideological) limits are necessary for constraining political agents if excessive transfers are to be avoided. When applied to the U.S. experience, it appears that these limits were eroded during the 19th century, paving the way for the modern redistributive state.

### A Principal-Agent Perspective

The principal-agent framework that has proved so useful for the study of the neoclassical firm can be fitted nicely to government once we accept the contractarian view. This contractarian view, developed by early philosophers and carried on today by such scholars as James Buchanan and Geoffrey Brennan (see Buchanan 1975; Brennan and Buchanan 1985), suggests that government is like a firm with which citizens contract in order to obtain protection, justice, and public goods. In this context constitutional, statutory, and common laws form the basis of the contract between governmental agents and citizens.

The literature on the contractual nature of the firm emphasizes transaction costs. In particular, this literature recognizes that when contracts are entered into, there are costs of measuring inputs and outputs and of monitoring agents. By explicitly recognizing these costs, we have come to better understand different forms of factor payments, leasing arrangements, franchising, and brand names. In this framework the neoclassical firm headed by a residual claimant becomes a mechanism for reducing transaction costs.

This principal-agent perspective is only beginning to be applied to governmental organization (see, for example, Kalt and Zupan 1984, Kau and Rubin 1979, and Peltzman 1984). The problem of insuring that the political agent acts on behalf of the citizen principal are fully as relevant as in the marketplace. Certainly transaction costs in the political sphere prevent perfect monitoring and measurement of agent performance and yield postcontractual opportunistic behavior. If the principal-agent relationship is not well specified and monitored in the political process, a transfer society can result. Large-scale rent

seeking comes from incomplete and inadequately enforced social contracts. Competition among agents and legal rules will constrain the amount of transfer activity that takes place, but the question is whether these constraints are sufficient. Given the limits to political competition and the costs of monitoring and enforcing social contracts, it is our contention that ideological or moral dimensions of political agent behavior complement constitutions in constraining the transfer society.

To understand the complementary relation between constitutional and ideological dimensions of constraining the transfer society, we present seven postulates that form the basis for a principal-agent theory of government. These postulates begin by asking how we are able to emerge from the Hobbesian jungle and proceed to the question of how can we control Leviathan in a world of positive transaction costs.

*Postulate 1.* In the Hobbesian state of anarchy, "life is nasty, brutish and short" because there are no clear rights, and hence there is no basis for exchange. Wealth in such a state is always up for grabs in that individuals can gain it by devoting resources to predation. In such a world human interaction will result in negative-sum games that deplete resources as people battle over wealth. Such conditions foster transfer activity or rent-seeking behavior.

*Postulate 2.* In the Hobbesian state of anarchy there is an incentive for members of the society to agree on constitutional-level rules for constraining rent-seeking behavior. To move out of this state individuals must agree to an initial set of rights and to restrictions on their ability to take mutually agreed upon rights from others. Agreement, however, is not sufficient to guarantee that such takings will not occur, for as North (1981, p. 45) has pointed out, "the neoclassical model has an asymmetrical dilemma built into its behavioral function":

It is certainly in the interests of a neoclassical actor to agree to constrain behavior by setting up a group of rules to govern individual action: hence the view that the Hobbesian state is a logical extension of the neoclassical model applied to a theory of the state. But it is also in the interests of the neoclassical actor to disobey those rules whenever an individualistic calculus of benefits and costs dictates such action.

To help overcome this dilemma, individuals consent to be coerced under certain conditions by the agency we commonly refer to as the state. The problem is specifying the agreement under which coercion is allowed to ensure a protective and productive role for the state.

*Postulate 3.* If transaction costs—that is, the costs of specifying and enforcing the contract—were zero, contracts to govern behavior and

protect rights would be instantaneous. The Hobbesian state of anarchy would never exist under this condition and only voluntary, positive-sum games would result because no wealth would be up for grabs. The value of all goods would be captured by their owners and all costs would be internalized. No social contract would be necessary because there would be no protective or productive roles for the state.

*Postulate 4.* Unfortunately, transaction costs are positive, making the dilemma North refers to a very real problem. As with any contractual arrangement between principals and agents, it is necessary to specify the contract in a way that will allow measurement and monitoring. In the case of a constitutional contract, agents are hired by principals to enforce the initially agreed upon rights, thus establishing the protective role for the state. In addition, agents may be called on to produce certain goods for which exclusion is costly within a private contractual setting.

At this point we emphasize that there are two levels of contracting in the political arena. The first, which we concentrate on here, is constitutional, wherein the fundamental rules that govern how agents will carry out the day-to-day operation of the state are established. The second level of contracting, which is the focus of most political economy, takes place between agent-politicians and principal-constituencies to provide the normal functions of the state. The higher rule of law, or the constitutional contract, is between faceless individuals who agree to constrain their behavior vis-à-vis other faceless individuals, and therefore comes closer to a contract formed behind the Rawlsian veil of ignorance. In contrast, everyday politics, or statutory contracting, is the result of special interest groups contracting for governmental protection, production, and redistribution. Our concern here is with how the constitutional level of contracting constrains the behavior of principals and agents in the process of statutory contracting.

Depending on the costs of measuring and monitoring the performance of political agents, it is possible for agents to engage in postcontractual opportunism, which involves attempts by parties to the contract to capture existing rents that, under the terms of the constitutional contract, were to accrue to other parties (Klein et al. 1978). Whenever property rights to rents (gains from trade) that result from contracting are not well defined and enforced, opportunism by one party is likely. If it is difficult to measure performance and monitor behavior, one party to the contract may be able to capture a portion of the rent that was supposedly the property of other parties.

Opportunities for postcontractual opportunism exist on many more margins as the transaction costs rise.

Postcontractual opportunism as used here refers to the actions of agents that violate the constitutional contract. When we suggest that such principal-agent actions lead to postcontractual opportunism, we mean that the constitutional contract is not sufficiently specified or *monitored to constrain agent behavior*. A violation at the constitutional level can result in principal-agent contracts at the statutory level, and these principal-agent relationships may adequately constrain opportunistic behavior. In other words, principals or special interest groups capture agents and thus obtain transfers. Such capture is possible because performance under the constitutional contract is inadequately measured and monitored.

The main question addressed by the literature on the contractual nature of the firm is what are the mechanisms used to reduce these transaction costs and thereby reduce the extent of postcontractual opportunism. This issue is illustrated particularly well when one party to a contract brings a specialized asset that has few alternative uses to the agreement. In this situation, the other party may agree to behave in a *certain way by providing other inputs* that, when combined with the specialized asset, generate greater output than the contracting parties could produce separately. Once the owner of the specialized asset agrees to the contract, he may find the other party threatening to withhold inputs with the intention of capturing more of the total rents. The fewer the alternative employment opportunities for the asset, the more it will be subject to postcontractual opportunism. It is in this context that Klein et al. (1978) find the explanation for vertical integration, which internalizes the rents associated with the specialized asset.

The point to emphasize in the case of firms with residual claimants engaging in private contracting is that there is an incentive to reduce the extent of postcontractual opportunistic behavior. Three aspects of private contracting make this the case.

First, there are clear residual claimants who receive the gains and suffer the losses when the contractual process works or does not work. Agents and principals alike must monitor the terms of the contract to insure that they capture the residual or gains from trade due them.

Second, since market transactions generate prices, these prices provide inexpensive information about the performance of agents. For example, even in a large corporation where there is a long chain of principal-agent relationships, the residual claimant *qua* stockholder can observe the asset price as a measure of contractual

performance. Even when the stockholder may remain rationally ignorant, individuals such as T. Boone Pickens have an incentive to attempt a takeover of the company, replace the "good old boy" agents (those engaging in postcontractual opportunism) with new agents, and make a profit. At least part of the information for such takeovers comes in the form of asset prices.

Third, postcontractual opportunism is constrained by competition. Potential residual claimants who perceive that agents are acting opportunistically can offer a better deal to principals. In this way, brand names, repeat business, and company goodwill become assets of the agent and constrain opportunistic behavior. Should a principal find that the product or service he expected from a particular firm differs from what is actually received, the principal can choose another agent. The greater the degree to which there is competition among potential agents, the less likely it is that any one agent can engage in postcontractual opportunism. The Klein et al. argument that owners of specialized assets with few alternatives are likely to experience postcontractual opportunism and therefore opt for vertical integration hinges on the lack of competition. Probably no force constrains agents more than competition from other agents.

*Postulate 5.* Because the three elements that constrain agent behavior in a private contractual setting are lacking when we consider constitutional contracting, postcontractual opportunism by political agents is more likely. Whereas private contracts have clearly established residual claimants, constitutional contracts with political agents have no such counterpart. For the principals, the residual claim on actions that benefit society as a whole are very small, since they are shared with a large number of others, thus giving these principals ample incentive to remain rationally ignorant. Political agents are usually restricted from making profits from their roles. In fact, in our society bribes are not an acceptable form of political payment, and extensive efforts are put into discovering political actions that lead to personal gain.

Furthermore, in the context of constitutional contracting, measurement of performance is difficult. There certainly are no "asset prices" quoted on the New York Stock Exchange that tell how well the government is being run, and the absence of profits means there is no clear yardstick against which to measure contract performance. In general the characteristics of products and services produced by the public sector are difficult to measure. For example, it is nearly impossible to measure the optimal amount of such public goods as national defense or environmental quality. Therefore we cannot be sure whether political agents are doing the job for which they were hired.

Finally, the very definition of government as an agency with a monopoly on legitimate coercion suggests that competition among political agents will be lessened. Recall that under a contractarian theory of the state, the citizen agrees to allow coercion by an agent in return for the guarantee that he will be spared the nasty, brutish, and short life inherent in Hobbesian anarchy. Wealth is then created through the definition and enforcement of property rights, but this wealth is "specialized" if it cannot be moved easily to another political jurisdiction; in other words, the wealth created through the constitutional contract is a potentially appropriable rent to the extent that there are not competing political jurisdictions. "Voting with your feet" (Tiebout 1956) is always an option if the coercive powers of government are used to appropriate these rents, but the costs of doing so are often quite high. To the extent that they are high, there will be less competition among agencies and more opportunities for agents to appropriate rents for themselves or for other principals. Therefore, we can predict less transfer activity to take place at the local level, where it is relatively easy to move to another town, and more to take place at the national level. The problem of postcontractual opportunism to capture rents from citizens is even greater at the national level if the government has the power to restrict emigration, as is the case with the Soviet Union.

The major check on opportunistic behavior by political agents is that if they successfully capture too many rents created by the constitutional contract, there will be competition by other political coalitions (see North 1979). Interest group theories of regulation argue that this type of competition allows the capture of regulatory agents. Of course, if the benefits from regulation were simply a redistribution of wealth from another small, well-identified group, the competition among agents would be keen, and there would be less likelihood that the transfer would take place. However, the ability of agents to diffuse the costs through general taxation or deficit spending while concentrating the benefits makes it more difficult for competing agents trying to reduce transfer activity to develop a constituency.

To recapitulate, the fundamental problem for government is to develop a contract between principals and agents that allows agents to protect private property rights and to produce certain public goods for which exclusion is cheaper because of coercive power, but which does not allow agents to use their coercive power to engage in transfer activity. In fact, however, political agents recognize that they can gain support if they provide transfers to specific interest groups. Unfortunately, the protective and productive outputs specified at the constitutional level are like common pool resources or public goods

where the benefits are diffused. Transfers, on the other hand, can be privatized by providing concentrated benefits. Agents seeking political support certainly recognize the difference between the two and act accordingly. Under these circumstances postcontractual opportunism in the form of transfer activity is likely to create Leviathan.

*Postulate 6.* One way of preventing political agents from acting opportunistically is to constrain them on as many margins as possible by carefully specifying the terms of the constitutional contract. At a minimum the contract must specify:

- The division of rents created by the initial contractual process. This would take the form of an agreed upon structure of property rights. These property rights, in essence, determine who has an ownership claim on wealth created as a result of the constitutional contract.
- The circumstances under which agents can exercise coercive power. The purpose and form of coercive power would be set out and limits on its use specified. For example, taxing power, due process, and decision rules must be delineated in the constitution.
- The methods of monitoring and enforcing contract performance by agents. A system of checks and balances among executive, legislative, and judicial branches would insure some monitoring by other agents. By specifying the role of different levels of government, it is possible to promote some competition at the state and local levels. For example, disallowing state interference with interstate commerce encourages states to compete for trade. Elections would also require a periodic review of performance and promote competition among agents. And to promote enforcement, a court system with an ultimate arbitrator and rules for removal of agents from office would be necessary.

*Postulate 7.* Of course, it would be naive to assume that margins for behavior could be sufficiently well specified to prevent all postcontractual opportunism. Even with private contracts that cover a narrow range of activities, the cost of specifying every margin will simply be too great. The constitutional contract—which covers a wide range of principal-agent relationships and has a monopoly on coercive power that necessarily limits competition from other agencies—is even less likely to prevent postcontractual opportunism.

At this point we must ask whether contractual performance by agents depends solely on narrow benefit-cost calculations regarding opportunistic behavior. As North (1981, pp. 46–47) states:



[W]e also observe them obeying the rules when an individualistic calculus would have them do otherwise. Why do people not litter the countryside? Why don't they cheat or steal when the likelihood of punishment is negligible compared to the benefits? . . . The question for social scientists becomes, how much additional cost will I bear before I become a free rider and throw the beer cans out the car window?

In all social interaction some rights are honored and rules obeyed simply because people have a sense of right and wrong. This sense is the ideology or morality that determines "the premium individuals are willing to incur not to free ride" (North 1984, p. 39).

Ideology defined in this way serves a useful purpose in reducing the costs of specifying and enforcing the distribution of wealth agreed to in a contract. For instance, a basic commitment to honesty or keeping one's word will substantially reduce transaction costs. In the absence of such an ideology, the gains from trade possible through market transactions would be substantially reduced.

Ideology will be even more important to contractual performance in cases where measurement is more costly and competition from other agents limited. If the sense of right and wrong for political agents is consistent with the intention of the social contract, there will be less postcontractual opportunism. For the constitutional contract to work, there must be some feeling among the parties that the distribution of wealth is just and some willingness to sacrifice increases in personal wealth to adhere to this distribution. However, if there is little agreement that the social contract is just, efforts will be devoted to using the governmental coercive power to redistribute wealth. Given that political agents are the ultimate enforcers of the constitutional contract through coercive power and there is no residual claimant, ideology becomes an important bonding agent for the social fabric.<sup>1</sup>

Gerald Sirkin (1976, p. 201) calls this bonding agent "Resource X," which represents "the self-disciplinary elements of Victorian compromise, the republican virtues and discipline of expectations that made individualism workable." Sirkin (p. 200) recognizes that

the discipline of authority must, in an individualistic society, be replaced by self-discipline. This need cannot be evaded by

<sup>1</sup>The view of ideology presented here is different from that of Kalt and Zupan (1984), who use the term to describe "on-the-job consumption" by agents. We have no disagreement with their description of this behavior as one result of postcontractual opportunism in the principal-agent relationship. Their emphasis, however, is on statutory levels of contracting, while ours is on the importance of ideology at the constitutional level.

individualistic choice of governmental authority, for, as long as the authority is individualistically chosen and is responsive to individuals, it will be no more disciplined than the individuals who chose it. Politics would then merely become the arena in which the chaotic bickering and mayhem occur.

If postcontractual opportunistic behavior by political agents is to be constrained, constitutional limits must complement and be complemented by an ideology consistent with the social contract. In the United States the social contract and ideology have been partially successful constraints on postcontractual opportunism.

## The U.S. Experience

### *The Constitutional Contract*

In the spring of 1787 a group of Americans gathered in Philadelphia to consider alterations to the Articles of Confederation. Adopted in 1781, the Articles had served as the contractual basis of the national government that followed the Declaration of Independence from England. Although the Articles had served well to coordinate certain governmental functions, they were seen by many as inadequate to the task because they did not provide for national taxation or the regulation of commerce. This constitutional contract also did not provide a national enforcement mechanism; it simply relied on the states to interpret and secure compliance with the provisions of the Articles. Thus, although a clear attempt was made to draw up a contract that would adequately empower agents to act on behalf of principals and also to limit their discretion, one can argue that the principal-agent relationship did not provide agents with sufficient authority to carry out their tasks.

The representatives from the states who met in 1787 were therefore committed to altering the existing contract or forging a new one. From the document framed by these men and the debate surrounding its writing and approval, it is evident that they had a clear understanding of the principal-agent problem and wanted to construct a contract that granted the agents enough power to accomplish their assigned tasks but also limited the agents' ability to engage in postcontractual opportunism. Their experience under the Articles of Confederation plus their relationship with the British Crown and Parliament before the Revolution provided ample reason to attempt to better specify the constitutional contract.

The concern for the adequacy of the contract between the principals and the agents was expressed in *Federalist*, no. 51, where James Madison wrote:

In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself. . . .

Ambition must be made to counteract ambition. The interest of the man must be connected with the constitutional rights of the place. It may be a reflection on human nature that such devices should be necessary to control the abuses of government. But what is government itself but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary.

In fact, the Federalist Papers can be viewed as a discussion of the necessity of an appropriately specified contract between principals and agents in the context of government. Much attention is given to justifying the Constitution as a document that appropriately constrains the agents and prevents postcontractual opportunism. There is a discussion of the role of the courts as a monitor of contract performance; of different spheres of influence for different parts of government as a way of maintaining competition; of the problem of a "tyranny of the majority"; and of the difference between constitutional or fundamental law (the basic contract) and legislative law. In *Federalist*, no. 78 Hamilton wrote:

A constitution is, in fact, and must be regarded by the judges as, a fundamental law. It therefore belongs to them to ascertain its meaning as well as the meaning of any particular act proceeding from the legislative body. If there should happen to be an irreconcilable variance between the two, that which has the superior obligation and validity ought, of course, to be preferred; or, in other words, the Constitution ought to be preferred to the statute, the intention of the people to the intention of their *agents* [emphasis added].

The Constitution embodied several different decision rules, depending on the nature and importance of the decision, providing yet another indication that constraints upon agent behavior were deemed necessary. Decision rules varied from one-fifth majority necessary to record a vote, to unanimity necessary before a state could be deprived of its vote in the Senate. Between these were rules of simple majority for most legislative decisions and two-thirds and three-fourths majorities for different parts of the amendment process.

In addition to constraining agents through a formal, written document limiting the power of government, the Constitution encouraged competition among agents. It specified the frequency of elections, and in so doing provided a compromise between stability in government and competition among agents so they could not completely

ignore the intention of the people. Competition was further enhanced by the last item in the Bill of Rights, which provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." This attempt to limit the domain of the federal government reflects the higher cost of exit at the national level and the benefits of competition among the state governments. Residual claimancy is also stronger on the part of the principals at the state and local levels, another consideration that was not lost on the Founding Fathers.

Three provisions of the Constitution were especially important for limiting postcontractual opportunism in the form of transfer activity. These were: (1) Article I, Section 10, the contract clause, which provides that "no state shall . . . pass any Bill of Attainder, ex post facto law or law impairing the Obligation of Contracts"; (2) Article I, Section 8, the commerce clause, which grants Congress the power "to regulate Commerce with foreign nations and among the several States and with the Indian Tribes"; and (3) Fifth Amendment (and later the Fourteenth), which provides that no person shall "be deprived of life, liberty, or property without due process of law."

All three clauses granted substantial security to private property rights and promoted positive-sum interaction through the market process. Freedom of contract and restrictions on the ability of states to interfere with commerce were necessary for social coordination through the exchange of well-enforced property rights.

The Supreme Court, particularly under Chief Justice John Marshall (1801–35), interpreted the Constitution in a manner that further solidified the document as an effective principal-agent contract. Marshall moved quickly to establish the Court's authority to review legislation and to negate legislation that was in conflict with the original contract. *Fletcher v. Peck* (1810) and *Dartmouth College v. Woodward* (1819) strengthened the contract clause and limited the ability of the federal government to hand out favors through contract modification. The Court also used the commerce clause to limit significantly the ability of states to use their coercive power to transfer resources, and the due process clause was an ever-present barrier to unlimited takings by government.

Over time, however, the interpretation of the contract changed in ways that made monitoring and enforcement more difficult. Early in the 19th century the contract clause lost some of its restrictive power when the Court decided that laws impairing the obligation of contracts were constitutional so long as they did not apply retroactively. But the most important alterations began with the decision in *Munn v. Illinois* (1877), which concerned the power of the Illinois state

legislature to set grain storage rates for elevators. Although precedent led many to predict the Illinois law would be declared unconstitutional, the Court ruled (94 U.S. 126 [1877]):

Property does become clothed with the public interest, when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created.

This became known as the public interest doctrine and was amorphous enough to leave a great deal of slack in the principal-agent relationship. With "public interest" unspecified, measuring and monitoring agent performance became more difficult. The problem was not so much that the power of government to regulate was expanded, but rather that such expansion was carried out in a way that agents could now find constitutional justification for numerous transfers of rights.

Further obfuscation of the contract occurred when the due process amendments were, over the next several decades, interpreted to mean that regulation of economic processes by states could occur, but that it must be reasonable. At times the doctrine of reasonable regulation was used to negate legislative interference with property rights, but at other times the Court deemed widespread intervention in the marketplace "reasonable." There was no specific constitutional provision by which courts could judge the reasonableness of any law; therefore it was clearly in the interests of affected parties to devote considerable resources to influencing both the legislative and judicial process.

The expansion of the regulatory power of government led to the creation of the Interstate Commerce Commission in 1887, and numerous other regulatory bodies soon followed. Again, the members of these bodies were serving as agents for the citizens of the United States, but there was no clear specification of the responsibilities of the members of these commissions or any provision for monitoring their performance.

Changes in the interpretation of the contract continued throughout the 19th and 20th centuries. Between 1875 and 1920 the police power of the state was increasingly used to justify interference with contracts. In several cases, particularly in *McCray v. United States* (1904), the courts granted the power to Congress to use its ability to tax to engage in explicit regulation. Also, in a series of cases between 1892 and 1911 the Court substantially expanded the power of the

legislative branch to grant discretionary power to the executive. Congress needed only to outline the basic policy objectives; then a regulatory board or commission could write the necessary rules to implement the mechanics of the law, and these administrative rulings were declared to have the force of law. Again, both of these trends made monitoring of performance difficult, particularly because there was no clearly specified obligation of the agent in his relationship with principals.

The Great Depression did not represent a significant watershed in constitutional doctrine, but there were several cases that led to a further lack of specificity in the contract. *Nebbia v. New York* (1934) upheld a New York law that allowed a state milk control board to set maximum and minimum prices. In this case the Court expanded the public interest doctrine first set forth in *Munn v. Illinois* and removed once and for all any doubt as to when economic activity was "affected with the public interest." The Court held that all activity was so defined and that a state could adopt "whatever economic policy may reasonably be deemed to promote public welfare." A second case, *N.L.R.B. v. Jones and Laughlin Steel Corporation* (1937), expanded the stream of commerce doctrine to include all production, and thus justified governmental interference with all economic activity on the basis of the presumption that the materials for the production process likely were drawn from interstate commerce and likely went back into interstate commerce.

Two more recent cases have significantly altered the intent of the original contract. In *Berman v. Parker* (1954) the Supreme Court neutralized much of the power of the Fifth and Fourteenth Amendments when it decided that the "public use" portion of those amendments did not substantially limit the power of government to engage in large-scale takings of property. Even more significant, in *Hawaii Housing Authority v. Midkiff* (1984), the Court allowed the Hawaii Land Reform Act of 1967 to stand. Under this act, the state's housing authority took property from large land owners and resold it to others. The justification for the legislation was the small amount and high price of residential land for sale on the islands. The act allowed the state housing authority to invoke eminent domain on behalf of those leasing land to then resell the land to the lessees. Thus, under the Court's recent interpretation, eminent domain is viewed as broadly as police power, leaving nothing that limits legislatures from engaging in wholesale takings.

The U.S. Constitution was designed to clearly specify the principal-agent relationship in government, to limit the ability of the agents to engage in postcontractual opportunism, and to provide a reason-

ably adequate basis for monitoring the performance of the agents. However, over the last two centuries, court interpretations have moved us to a much more ambiguous and less clearly specified contract. The opportunity for agents to shirk is much greater than previously, since there are many more margins at which postcontractual opportunism can occur. In the absence of a well-specified and enforced contract, more reliance must be placed on ideological constraints on agents.

#### *Ideological Constraints on Transfers*

Just as the constitutional contract constrained political agents, attitudes toward property during the first century of our nation's history reduced enforcement costs. Over time, however, these attitudes and enforcement costs have changed. The evidence suggests that ideology was a useful complement to the U.S. Constitution during the earlier period.

One of the distinguishing features of colonial America was the general acceptance of the Lockean concept of natural rights. This concept provided the colonists with a generally understood common point for determining the origin and sanctity of rights.<sup>2</sup> Although classical writers, including Plato and Aristotle, had a type of natural rights philosophy in their works, their position tended to emphasize the duties of man rather than the rights of man (Strauss 1953, p. 182). It was not until John Locke published his *Second Treatise on Civil Government* in 1690 that a more complete theory of the rights of the individual to property was put forth. Locke argued that the right to self-preservation gave the individual the right to any property with which he mixed his labor. This right of appropriation, however, was not limited to only that for which he had an immediate use. Since money allows for store of value and trade provides a mechanism whereby property of less value can be bartered for property of greater value, Locke believed natural rights were unlimited. Under Locke's theory, property rights were not created by government or by law, but were a part of the natural order of the universe. Therefore anyone who knowingly violated another's property was morally guilty of violating one of the basic universal principles of life.

The general acceptance of the concept of natural rights was found in everything from colonial education to religion to politics. Speaking of property in 1768, Samuel Adams (1949, p. 66) said "it is an essential, unalterable right, in nature, ungrafted into the British Constitution,

<sup>2</sup>See Hofstadter (1977) for a good discussion of colonial attitudes regarding natural rights.

as a fundamental law, and ever held sacred and irrevocable by the Subjects within the Realm, that what a man has honestly acquired is absolutely his own, which he may freely give, but cannot be taken from him without his consent."<sup>3</sup>

In higher education the influence of natural rights was reflected in the teaching of John Witherspoon, president of Princeton University from 1768 until his death in 1794. In both their junior and senior years, students attended Witherspoon's lectures on moral philosophy. In attendance at those lectures were numerous future leaders, including 1 president, 4 members of the Second Continental Congress, 15 senators, 24 congressmen, 3 Supreme Court justices, and 12 state governors (Persons 1958, p. 136). Persons (1958, pp. 136–37) summarizes Witherspoon's lectures on moral philosophy:

Moral philosophy as taught by Witherspoon consisted of three branches: ethics, jurisprudence, and politics. Each dealt with different aspects of moral obligation in human relationships and was properly studied in conjunction with the others. . . . Witherspoon devoted considerable attention to the rights and obligations of property. Prevailing practices with respect to private property were, he believed, a good index of the moral character of any society.

Further evidence of the respect for property rights can be found in recorded thoughts and teachings of colonial ministers.<sup>4</sup> The clergy, particularly in New England, were well-educated, commanded great respect, and were seen as a source of authority (Baldwin 1965).<sup>5</sup> They were responsible for educating and persuading the populace on theology as well as political theory and natural science. In addition to regular Sunday sermons, ministers gave lectures on a weekly basis and addresses on special occasions such as election day. In view of their considerable influence, it is significant that the clergy felt strongly and spoke so fervently on liberty and rights. As Baldwin (1965, p. xii) points out:

The New England clergy preserved, extended, and popularized the essential doctrines of political philosophy, thus making familiar to every churchgoing New Englander long before 1763 not only the doctrines of natural right, the social contract, and the right of resistance but also the fundamental principle of American constitutional law.

<sup>3</sup>See Corwin (1955) and Strauss (1953) for a more complete discussion of the development of the doctrine of natural rights.

<sup>4</sup>See, for instance, Cole (n.d.) and Baldwin (1965).

<sup>5</sup>Forty-eight of 52 ministers in New Hampshire in 1764 were college graduates (Baldwin 1965, p. 3).



Political leaders also accepted the doctrine of natural rights and built institutions around it. Both the Declaration of Independence and the Constitution strongly reflect the Lockean concept of the compact theory of the state, namely, that government derives all of its powers from the consent of the governed and is created to protect natural rights including the right to property. The Founding Fathers saw as their primary task the construction of a system of government that possessed enough power to carry out the minimal functions of the state, yet not so much as to violate fundamental rights or allow agents to engage in postcontractual opportunism. In fact, so strong was their belief in fundamental rights that many opposed the Bill of Rights on the grounds that such fundamental rights did not have to be enumerated.

Thus, the principal-agent problem was partly solved by the adherence to a natural rights doctrine, which provided an additional means of contract enforcement. Because both the principals and the agents shared a philosophy that defined a set of rules (property rights) governing the division of rents, more explicit specification of the contract was not necessary. The use of ideology to aid in enforcement of the social contract continued through much of the 19th century. As late as 1868 the Supreme Court invalidated a statute on the grounds that it violated vested rights without reference to any explicit provision of the Constitution. Nineteenth-century moral philosophy continued to reflect a natural rights view. For instance, Francis Wayland's popular *Elements of Political Economy*, published in 1837, continually emphasized the sanctity of property rights (Persons 1958, p. 196).

However, even in the 19th century, doctrines were beginning to take hold that would eventually lead to the downfall of natural rights theory. An attempt was made to replace nature with history, or to find the rights of man in the historical process. "The end result of that attempt was absolute and unqualified failure. The attempt to replace natural right with historical right ended not in historical political philosophy, but in nihilism" (Jaffa 1978, p. 9). Likewise, the growth of utilitarianism led to less adherence to natural rights, as the idea of "greatest good for the greatest number" justified redistribution without consent of property owners.

The universal validity of the natural rights doctrine was also being challenged. While the 18th-century mind considered man's basic nature and moral standard to be invariant in time and space, historian Richard Hofstadter (1959, pp. 16-17) states:

But no man who is as well abreast of modern science as the Fathers were of eighteenth-century science believes any longer in unchanging human nature. Modern humanistic thinkers who seek for a

means by which society may transcend eternal conflict and rigid adherence to property rights as its integrating principles can expect no answer in the philosophy of balanced government as it was set down by the Constitution-makers of 1787.

Further evidence of the change in attitude toward universal principles can be found in *Situation Ethics* (1966) by Joseph Fletcher. The premise of the book is that any action can be right, depending on the situation. Again, a defense of property rights can be derived from such an ethical standard, but there will be continual conflict over rights. Also, situation ethics and moral relativism have led to moral nihilism. The argument that all moral questions are pragmatic or relative questions has led many to the position that no moral judgments can be made about anything. To the extent that these moral judgments cannot be made, ideology as a constraint on postcontractual opportunism loses much of its power. The result of this amorality is captured by William J. Bennett (1976, p. 915):

The dangers of the myth [of the ethical sufficiency of law] are evident. Its tendency to make society more litigious, its emphasis on a compulsory morality rather than a voluntary one, encourages a morality of threats, which is in fact no morality at all. Recourse to law and courts occurs most often because private settlement and ordering have failed.

This politicization of society means that many issues traditionally treated as private moral questions become sources of legal conflict. As Robert Nisbet (1975, p. 5) puts it, we are at a "twilight of authority":

What we are also witnessing, and this tragically, is rising opposition to the central values of the political community as we have known them for the past two centuries: freedom, rights, due process, privacy, and welfare. . . . To lose, as I believe we are losing, this structure of values is surely among the more desolating facts in the present decline of the West.

To the extent that respect for property as an ethical standard is declining, clear specification and monitoring of the principal-agent relationship can only occur if additional resources are devoted to the process. In the absence of a strong moral belief in the sanctity of private property rights, a strongly enforced constitutional contract is the only deterrent of transfer activity. Though we have not found a way to quantify the impact of ideological change, it is clear ideological convictions were changing the principal-agent relationship. North (1981, p. 198) summarizes the impact of these changes:

The clearest reflection of ideological transformation was the evolving attitude of the judiciary. The gradual transformation of the attitude of the Supreme Court was a long process. . . . The ideological

transformation was still in process by 1914, but it would be established definitively in the 1930s.

With the Great Depression and the writings of John Maynard Keynes came the solidification of the transfer society. What Buchanan (1985) has called "Victorian fiscal morality" allowed political agents to use debt financing as a fiscal tool only during wars and serious business downturns. Certainly the Great Depression fit the latter category, but the use of deficit financing did not stop with the 1930s. Buchanan (1985, p. 1) writes that in this century debt financing has "ceased to be immoral," although perhaps "rationally chosen constraints can be introduced to serve, *in part*, as substitutes for the eroded moral rules" (emphasis added). But without complementary ideological constraints on fiscal responsibility, it is questionable how long the substitution of explicit rules for moral norms will work.

### Conclusion

We have argued that the Founding Fathers' respect for property rights derived from their belief in natural rights, and this belief exerted a significant constraint on individual behavior. They believed that in order for self-government to succeed, a strong influence from the ethical code was also essential. In other words, as James Madison wrote, "To suppose that any form of government will secure liberty or happiness without any virtue in the people, is a chimerical idea."<sup>6</sup>

Nevertheless, the Founding Fathers did not feel that people automatically respected rights, particularly when the coercive power of government could be used to violate rights. Madison felt that "neither moral nor religious motive can be relied on as an adequate control" (*Federalist*, no. 10). Alexander Hamilton's position in *Federalist*, no. 6 was even stronger:

To trust to man's inherent goodness would be to forget that men are ambitious, vindictive, and rapacious. . . . Has it not, on the contrary, invariably been found that momentary passions, and immediate interests, have a more active and imperious control over human conduct than general or remote considerations of policy, utility or justice?

To reinforce the ideological constraints on political agents, the Founding Fathers were willing to invest resources in contractual mechanisms that would serve to protect natural or vested rights.

<sup>6</sup>Quoted in Bennett (1976, p. 910). Also see Landi (1975) for a discussion of Madison's view of the good society. Landi argues that Madison saw virtue and its pursuit as important to the good society. Liberty was viewed as an important condition for such pursuit.

Given the respect for rights generated by the natural rights doctrine, however, enforcement could occur with a relatively small commitment of resources.

Buttressing the constraints created by belief in natural rights and the explicit constitutional rules was the decentralized nature of early American society. "If Americans early displayed a strong interest in laws and institutions limiting the exercise of political authority, they also pioneered in the development of self-sustaining local government" (Roche 1969, p. 229). Even in the absence of an ethical code, respect for property was observed in small communities, in part, due to the expected costs of violating the rights of others. The smaller the group, the lower the costs of monitoring political agents because information is more readily available. Changes in these monitoring costs have greatly influenced the effectiveness of constitutional constraints.

One of the most significant changes in the costs of violating any given ideological standard has come with increased urbanization. As Buchanan (1978, p. 365) states, "The force of moral-ethical principle in influencing behavior is directly dependent on the size of community within which action takes place." Monitoring costs increase significantly as a large portion of one's social interaction takes place with other individuals who will never be seen again. In 18th- and early 19th-century America, almost every individual acted in a social setting in which he or she was familiar to others. Even those who worked in a factory lived in close proximity to their workmates. In 1790 only 5 percent of the population resided in urban areas of 2,500 or more.

The increasing industrialization, growing national markets, increasing occupational and geographic mobility, rising agricultural productivity, and improving urban transportation made cities much more economically viable. By 1970, 73 percent of the U.S. population was living in urban areas containing 2,500 or more residents. Thus, antisocial behavior, or lack of respect for others rights, resulted in less social disapproval.

During the past century there have been few explicit changes in the social contract governing political agents, but there have been significant changes in the costs of monitoring and enforcing that contract. Economic historians studying the growth process have focused almost entirely on technological changes with accompanying economies of scale that have altered the degree of centralization in our society. What they have not considered is why and how ideology has changed.

Our focus has been on the complementary relationship of constitutional and ideological constraints on principal-agent relationships. Constitutions without the appropriate accompanying ideology are likely to fail. No document can adequately protect all the potential margins from postcontractual opportunism. Once the coercive power is in place the principal-agent problem is almost intractable without some general acceptance of appropriate behavior standards by both parties. Many South American countries have had constitutions similar to the U.S. Constitution, yet they generally have failed in their attempts at constraining both the principals and the agents.

Likewise, attempts to constrain postcontractual opportunism through ideology in the absence of a formal, written document are likely to be less than successful. The English common law system, for example, illustrates the difficulty of enforcing a social contract without a clear-cut specification of the terms of that contract. Although the English courts have used the concept of an original social contract to negate legislation contrary to that contract, the absence of a written document has made it difficult to monitor performance and to determine precisely when the contract has been violated.

We believe that the principal-agent approach to the study of government allows important insights into the nature and scope of government. This approach suggests that the lack of a clear residual claimant, the lack of competition due to the high costs of exiting from the contract, and the high costs of monitoring and measuring performance in the absence of prices have all contributed to the growth of our transfer society. Only a combination of explicit constitutional rules and an ideology consistent with those rules can constrain the transfer society. Therefore, the task for social scientists is to develop a theory that explains why the ideological constraints that existed at the birth of our nation have eroded.

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## IDEOLOGY AS THE ULTIMATE ENFORCEMENT MECHANISM

*Thomas S. McCaleb*

Professors Anderson and Hill (1986) attempt to explain the growth of rent seeking in American society in the following way. Governments emerge to reduce unproductive rent-seeking activities. Once governments with coercive powers are created, however, constraints must be imposed on political agents to prevent or minimize rent seeking within and through government. Social contracts are one form of constraint on government, but the constraints of social contracts must be supplemented by ideology to be fully effective. American constitutional history is characterized by a deterioration in the constraints imposed by the social contract, necessitating increased reliance on ideology.

In this analysis Anderson and Hill adopt the “new” contract theory of the state—an application of the economic analysis of principal-agent relationships—as an explanation of the existence of government. Although I too have used this contractarian framework, it clearly has limitations. Anderson and Hill seem less aware of or less concerned with the limitations than I have been. I believe the contractarian approach is most appropriately viewed as a “what if” statement. What if the origins of the state lay in a social contract by which individuals organized themselves to establish property rights and thereby to promote more efficient utilization of resources? Then, what sorts of rules and institutions of government would logically be established to accomplish those ends?

Anderson and Hill, on the other hand, seem to have adopted the contractarian approach as a positive, descriptive theory of the origins of government. They seem to believe that governments really were

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consciously created by the citizenry as explicit solutions to the rent-seeking problem. But my limited reading of history makes me somewhat skeptical of the historical accuracy of the contract theory of the state. I believe one could make a strong case that fundamentally, in a historical sense, the state was a creature of power that emerged as the ultimate rent-seeking agency without any artifact such as a social contract, whether explicit or implicit. The social contract, if it exists, is of relatively recent origin.

At the same time, while I am skeptical of Anderson and Hill's interpretation of the contract theory of the state, I strongly concur with their emphasis on the role of ideology, or what I prefer to call the civic culture, a notion recently popularized by Douglass North (1981).<sup>1</sup> To see the importance of ideology, or the civic culture, as a glue that holds society together and makes social interaction possible, it is only necessary to think about a community that relies on contract alone to govern interpersonal relations. Each contract represents a transaction that provides mutual gains to all of the parties to the contract and therefore improves the total well-being of the individuals involved. In the absence of any enforcement mechanism, however, some parties to the contract could obtain a disproportionate share of the available gains by violating the contract. If all engage in such nonsocial behavior, the contract breaks down. To reduce nonsocial behavior, an ultimate enforcement mechanism—government—is created by social contract. The unresolved problem for the contractarian view of society, however, is who or what prevents nonsocial behavior among the enforcers. Ideology, or the civic culture, provides an answer.

In a recently published paper, Richard Wagner and I (McCaleb and Wagner 1986) looked at attempts to test empirically one form of nonsocial behavior, the phenomenon of free riding. First, there were several experimental studies that found at most only a moderate degree of free riding, and in some cases very little free riding at all. Then there appeared a second group of studies, quite critical of the first, that argued that the earlier studies were improperly constructed and were contaminated in ways that biased the outcome of the experiment against free riding. This second group of studies constructed experimental environments that were cleansed of these allegedly contaminating elements, and not surprisingly they were then able to show evidence of a greater degree of free riding.

<sup>1</sup>The term "civic culture" is borrowed from Almond and Verba (1963), although I use it in a different (but not unrelated) context.

But Wagner and I noticed something very interesting. No matter how pure an environment was created in this second group of studies, *no matter how strongly the structure of the experiment favored free riding, no experimental study produced results consistent with complete or even strong free riding. Clearly, something other than the calculus of immediate measurable costs and benefits motivates human action, even in a purely experimental setting. We attribute this outcome in part to the strength of the civic culture that is imparted, beginning at birth, in every civilization. Societies create all sorts of other institutions, some of which have been extensively analyzed in the economic theory of contract, to alleviate the incentives toward nonsocial free riding behavior, but ultimately these devices must rest on the existence and observance of the civic culture.*

Once one recognizes the importance of ideology or the civic culture for the efficient operation of societies, it is fair to ask why the social contract is needed at all. Indeed, one could argue that the social contract where it exists creates its own inefficiencies. As the social contract closes off some avenues of rent seeking, agents find other less efficient avenues. If agents are prevented from seeking cash subsidies from governments, they will arrange for less efficient non-cash subsidies or they will attempt to transfer wealth to themselves through such cumbersome and inefficient regulatory devices as price controls, occupational licensing, and so on. It is arguable then whether society might not be better off with open, direct rent seeking not constrained by social contract. In fact, the most efficient, perhaps the only, mechanism for closing off the obvious and direct avenues for rent seeking without redirecting rent-seeking activity into less desirable and less efficient channels is the inculcation and promotion of a civic culture that militates against rent seeking.

Anderson and Hill argue to the contrary that attempts to restrain nonsocial behavior through ideology alone will be less successful in the absence of a formal written social contract or constitution. As evidence they cite the difficulty in England of "enforcing a social contract without a clear-cut specification of the terms of that contract." But do we have any firmer notion of the terms of our social contract than do the English? Indeed, we have recently been told by one of our Supreme Court justices that the terms of our social contract will be adjusted to fit whatever notions of right might prevail among him and his brethren at any time. This hardly seems to be the stuff of which clear-cut specifications are made.

Fundamentally, I am unsure that Anderson and Hill's distinction between social contract and ideology is really meaningful. Ideology is the ultimate enforcement mechanism without which any form of

contract, social or otherwise, would be of little use. The historical breakdown of constraints on rent-seeking behavior did not occur because the social contract had been weakened, necessitating greater reliance on ideology. Rather, the civic culture itself has changed, and the interpretation of the social contract has followed that change in the civic culture. Placing greater reliance on this changing ideology is not then a solution to the problems perceived by Anderson and Hill. Only by remolding the ideology or civic culture can a more preferred state of affairs be obtained. For this reason, reliance on constitutional alterations such as the proposed balanced budget amendment to constrain rent-seeking behavior by political agents is doomed to failure without an accompanying change in the civic culture. In the absence of change in the civic culture, such amendments may well raise the costs imposed on society by rent-seeking activity if they redirect that activity into less efficient channels.

The reliance that Anderson and Hill place on the potentially constraining influence of the social contract arises from a common methodological fallacy. Anderson and Hill frequently emphasize the successes of private contracts in channeling economic and social activity into mutually beneficial directions, but I fear that sometimes they are all too sanguine about imperfections in private contractual relations. Public choice economists have long criticized social welfare economists for emphasizing market failures while assuming perfect performance by government. There has been of late, however, a rather pronounced tendency on their part to emphasize government failure while assuming the near-perfect performance of private markets. Although not egregious, I believe that this fallacy is suggested by Anderson and Hill's discussion.

For example, Anderson and Hill place great reliance on business mergers and acquisitions as the ultimate protection of shareholders against nonsocial rent seeking by business managers. In fact, managers have available to them a number of devices to make such acquisitions costly, thereby providing some protection for rent seeking within the firm. Not the least of these is managerial control over important information about the firm. Accounting data are, after all, based on convention and are subject to manipulation, thereby making the monitoring of managerial behavior costly for shareholders and potential management rivals alike.

Neither the perfect government nor the perfect market viewpoint is valid. Nonsocial behavior in the form of free riding, rent seeking, and so on poses potential problems for all social interaction. Communities successfully utilize a variety of methods for ameliorating the perverse effects of such behavior. Some institutional arrange-

ments exist in private markets, including but not limited to various forms of contractual arrangements. Other institutional arrangements exist within or are provided through government, including the establishment and enforcement of property rights without which private contractual arrangements would be of little value. All of these institutional arrangements leave substantial room for nonsocial behavior, so that the ultimate constraining influence must be non-institutional, that is, ideology or the civic culture.

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