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A Nozick–Buchanan contractarian governance as solution to some Invisible Hand failures

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Abstract

We show how contractarian governance may restore Pareto-optimality in a class of *symmetric*, *proportional* and *budget balanced* decentralized production environments, which, under laissez faire, normally results in Invisible Hand failures (IHF). We formulate a governance in the spirit of Buchanan, which chooses that particular Sen tax that restores Pareto-efficiency under membership symmetry. The rules governing the choice of the Sen tax will be adopted unanimously by rational agents and no alternative governance can do better. Under membership asymmetry, we introduce the possibility of partitioning the community into subgroups of identical members. Then a set of K contractarian Sen taxes potentially solves the set of K IHFs. Partitioning is implemented by the federalist program of Buchanan and Nozick.

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1. Introduction

In the neoclassical economic tradition, interventive governance enters only as a response to a *market failure*. Where the market is efficient, governance is distinguished only by its absence. In the perfectly competitive, private ownership, market economy, the governance that

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supports Pareto-optimality is *laissez faire* or A. Smith's *Invisible Hand* (1776). A standard exercise in Economics is to show how an intervention may restore Pareto-optimality in the face of some non-convexity or externality, which blocks Pareto-optimality, e.g., Pigovian taxes may restore Pareto-optimality in the presence of some consumption externality or a tax-and-bounty scheme may do the same under some production externality.

How these interventions are crafted and by whom are governance issues largely exogenized. Pigou viewed this as the economic impetus for the *state*, invented, so to say, by necessity, just as Hobbes perpetual *state of warre* that results in life being "cruel, nasty, brutish and short" is the political trigger of the Leviathan. Coase (1960) tried to evade the Leviathan issue by showing how Pareto-efficiency can be attained under externality if property rights can be defined and assigned, transactions cost of exchange is low and equity issues can be ignored or addressed by some credible ex post redistribution scheme. The "ifs" confronting the Coase theorem are, however, fundamental governance issues that again require a Leviathan to exist if pushed back to more basic tasks. Who decides and how they decide on an intervention is an important unaddressed issue. A sovereign may craft and enforce the requisite Pigovian taxes but may also give in to absolute corruption with absolute power. Or decision on intervention may be subject to J. Locke's "consent of the majority" which pushes the social contract beyond the mere choice of a sovereign to matters of laws and taxation. Whether such contractarian intervention for particular Invisible Hand failures leads to Pareto-improvements requires demonstration.

One mechanism that can implement the contractarian program is federalism. Federalism is usually defended on classical liberal grounds as a means of restricting the power of central government (Buchanan, 1999). Citizens are allowed to choose one from a set of competing sub-communities whose package of characteristics (constitution, tax laws, public goods) is closest to their own ideal. Through a program of *open entry* and *voting with one's feet*, the whole polity is effectively partitioned into groups, each of whose membership minimizes heterogeneity. This is Buchanan's (1999) *competitive federalism* as well as Nozick's *filter* (1974). There is a lively debate associated with federalism (Buchanan, 1991; Hamlin, 1985, 1991; Berggren, 1996), especially with the monetary unification in Europe.

At the heart of most federalist ideas is a fundamental respect for the individual decision-maker in the political sphere. Buchanan and Tullock (1962) proposed to extend consumer sovereignty in the market to the choice of governance. Citizens should be able to choose from a set of possible constitutions and not just vote *yes* or *no* to a particular one or to a particular candidate. Federalism, therefore, extends the democratic ideal of "government by the people" to the choice of constitutions. The implied contention appears to be that such a contractarian federalist arrangement best serves the economic utilitarian principle of "the greatest good for the greatest number," as it minimizes the negative externality on the minority of majority rule. We refer to this as the *contractarian federalist conjecture*. How does "government by the people" in the form of contractarian governance lead to the Pareto-optimum which, in Economics, proxies for "the greatest good for the greatest number"?

Invisible Hand failures (*IHF*) exist whenever voluntary and self-interested behavior of economic agents leads to a Pareto-suboptimal outcome. *Market failures* form the most important subset of IHFs. Examples of IHFs are the *tragedy of the commons*, the *Prisoner's dilemma*, the under-provision of public goods, economies with externalities, the