Polycentricity, Political Economy, and the Welfare State

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Abstract

This paper uses the welfare state as a vehicle for contrasting alternative theoretical orientations toward political economy: one orientation conceptualizes the state as an organization; the other, which is embraced here, conceptualizes the state as an order that in turn contains numerous organizations. The programs associated with the welfare state are thus emergent outcomes of polycentric processes and not the product of some actor's maximizing choice. Among other things, this alternative conceptualization provides a different orientation toward state-sponsored redistribution.

Keywords: welfare state, income redistribution, polycentricity, spontaneous order, order vs. organization, constitutional political economy

JEL Codes: D6, D7, H4, I3

Polycentricity, Political Economy, and the Welfare State[1]

The welfare state is an object of continuing controversy, as surveyed in Barr (1993) and presented in debate format in Schmidtz and Goodin (1998). Its programs of social insurance and public assistance have often been characterized by the image of a safety net (Weicher 1984). Controversy over the welfare state revolves around the relative roles for private and collective action in the construction of safety nets, with critics arguing that collective action is generally inferior to market action in providing safety nets. This claim is illustrated for social insurance for medical care and retirement by such authors as Ferrara (1980) (1990), Ferrara and Tanner (1998), and Goodman and Musgrave (1992). This claim is likewise illustrated for programs of public assistance by such authors as Beito (2000), Mead (1986), Murray (1984), Olasky (1992), and Tanner (1996). The critical arguments over the welfare state have, of course, been strongly contested, as illustrated by Atkinson (1997), Bane and Ellwood (1992), Diamond and Orszag (2005), Gans (1995), Gilbert (2002), and Goodin (1998).

It is worth noting that this debate over the welfare state is limited to claims that social insurance and public assistance can be provided more effectively through market-based firms than through state-based agencies. For instance, Daniel Shapiro (2007) titles his book *Is the Welfare State Justified?* While he announces that he answers his question negatively, he really doesn't. He doesn't propose truly to abandon all collective participation in the provision of personal security. Rather, he proposes only to revise the welfare state by replacing state agencies with market firms. People would still be forced to participate in those programs through forced saving, only their contributions would accrue to their individual accounts which they could spend as they directed within programmatically-stipulated limits. In this respect, we should remember that a state can accomplish through regulation anything it can accomplish through budgeting. For example, a state could abolish its education budget by requiring parents to send their children to approved schools. This duality of regulation and budgeting means, among other things, that regulation can not be ignored in an examination of the welfare state even though the welfare state is normally associated with budgetary operations.

While I too have written critically about the welfare state (Wagner 1989), my interest here does not lie in contributing to discussions of possible reform. Rather, it lies with the theory of political economy and how the welfare state might fit within this theory. Political economy denotes some form of interaction between the domains of polity and economy; however, there are different ways of conceptualizing those domains and their interaction, which in turn yields different orientations toward political economy. This paper starts by exploring alternative conceptualizations of polity within a theory of political economy. Orthodox political economy construes the polity as a goal-directed organization that reflects the maximizing choices of some political agent. In contrast, I construe polity as an order that contains numerous goal-directed organizations within its domain. After exploring these alternative conceptualizations of political economy, the remainder of the paper explores some of the differing insights that arise when polity, like economy, is conceptualized as a polycentric order and not an organization.

Orders and Organizations; Parades and Crowds

A theory of political economy concerns the relationship between two objects of inquiry denoted as polity and economy. There are different ways to conceptualize political economy, as noted by Staniland (1985). Such differences arise largely because these objects of inquiry are not apprehensible directly by the senses. They are abstract nouns that can be brought into focus only through some prior act of theorization. While such objects as factories and shops are apprehensible directly by the senses, the object we denote as economy is a theoretical construction. Similarly, such objects as a mayor's office and a parliamentary chamber are directly apprehensible, but the object we denote as polity is constructed theoretically. Our observations of polity and economy reflect prior acts of theorization to grasp the object of inquiry. It is the same with the compound object political economy, which denotes some type of relationship between the objects denoted as polity and economy; moreover, just what kind of relationship is represented by the compound noun political economy is also a theoretical construction about which choices exist.

A prime element in differentiating among theories of polity, economy, and political economy is the place of order and organization (Hayek 1973) within those theories. Orders and organizations are each social configurations that contain a multiplicity of participants. Both forms of configuration are intelligible to an observer, in that in both cases the actions of the participants appear to be reasonably well coordinated with one another. A marching band and a crowd of spectators leaving a stadium each represent coordinated patterns of movement. While each type of configuration is orderly in that it presents an intelligible pattern to an observer, the source of orderliness differs between the configurations. This difference in source bears significantly on theories of political economy.

The marching band is an organization, as is a firm or a bureau. Ideally, its members march as a single unit as directed by a conductor. Without doubt, some marching bands march and play better than others. If shown film of different performances, the members of differing bands would have relatively little difference in ranking performances, at least up to the limit of their ability to process information (Miller 1956). There is a reasonable image of a perfectly coordinated marching band, which would correspond with the image of an award winning band. Many bands fall short of this ideal standard, and so would be accorded some measure of imperfection. It is reasonable to assign a measure of imperfection or inefficiency to an organization because it is a goal-centered team (Alchian and Demsetz 1972). Team processes might not operate smoothly, and it is the task of management to secure efficient team production; nonetheless, it is reasonable to describe the members of an organization as participating in the pursuit of some common end, and with the extent to which that end is attained being subject to general agreement among the participants.

The crowd of spectators leaving a stadium is also orderly, in that the observed pattern of movement is intelligible to an observer; however, the spectators comprise an order and not an organization. A moving crowd is a different type of social configuration, ontologically speaking, from a marching band, and social theory is better served when the theories employed are suitable for the objects being examined, as Lawson (2003) explains. The order of a crowd of spectators does not arise from the plan of some conductor. Rather, that order emerges through interaction among the individual spectators, each of whom pursues an individually-chosen path or objective while also engaging in continual readjustment in response to the similar efforts of other spectators. The marching band represents a single teleology in motion, with the individual members embracing that teleology when they join the band. In contrast, the crowd of spectators does not represent one teleology in motion but rather represents multiple individual teleologies that appear coordinated through the continuing efforts of the spectators to adjust their movements to one another. To treat the crowd as an organization is to commit what Resnick (1994) calls the centralized mindset, wherein the observation of an orderly pattern is attributed to some organizing agent when it is really an emergent feature of interaction among participants, which in turn was a theme set forth lucidly by Schelling (1978).

Order, Organization, and Political Economy

All theories of political economy treat economy as an order; this is the foundational point of departure for all economic theory. To be sure, some theories threaten to squeeze the spontaneous part out of the ordering process by imposing general equilibrium as an analytical point of departure rather than treating it as a tendency of market processes. Nonetheless, economic theory rests on a foundation of spontaneous order theory.

It is different for polity and, hence, for political economy. Most theoretical efforts treat polity or state as an organization and not an order. This treatment might be reasonable for autocratic regimes wherein the head of state might be analogized to the CEO of a corporation. In this respect, Knut Wicksell (1896 [1958, p. 82]) lamented that "the whole theory [of public finance] still rests on the new outdated political philosophy of absolutism." While recent works in political economy, as exemplified by Barzel (2002), Besley (2006), Drazen (2000), and Persson and Tabellini (2000), treat democratic and not absolutist regimes, the underlying conceptual orientation remains that of absolutism. The polity is assimilated to a marching band and not to a moving crowd of spectators. The polity is treated as a goal-directed organization, with theories of political economy differing only in how or what goals are selected. Where autocratic regimes might be assimilated directly to some ruler's choice, democratic regimes differ only in the method of selecting what is effectively the occupant of an autocratic position. The central model of democratic political economy is one where state policy reflects the efforts of candidates to compete for support of the median voter. Hence state policy is still a product of an organization, in this case one that is headed by the median voter, and not something that arises spontaneously out of an order of relationships among people.

Figure 1 illustrates this common treatment of political economy. In the lower part of the figure the circles denote the enterprises that constitute the market order. Those enterprises are shown to form a loosely connected network, much as a crowd of pedestrians would form a loosely connected network. The nodes denote the enterprises within the market while the edges denote the connections among the enterprises. While some of those enterprises are more densely connected than other enterprises, the configuration of market enterprises corresponds to a polycentric arrangement and not to some hierarchically organized entity. This network of market-based enterprises denotes the economy portion of political economy.

The triangles in the upper part of Figure 1 denote the polity. The polity is denoted by five fully connected entities or enterprises. The pattern of complete connection denotes that the polity acts in coordinated fashion as a unit, as does a marching band. While the polity is characterized as an organization and not an order, its particular mode of operation will reflect its constitutive framework. For an autocracy the polity might be represented by a rent-maximizing autocrat who operates in corporate fashion with five divisions or branches. For a democracy it might be represented by a competitively elected ruler who operates with five ministers, and perhaps with electoral competition operating to compete away some of the rents that might accrue under autocracy. In either case, however, the central feature of this analytical framework is that the polity is conceptualized as an organization, as a type of firm.

The double-sided arrow in Figure 1 indicates that polity and economy are treated as distinct and separable entities, with the aggregate social outcome being generated by addition across the two domains of action. To be sure, actions by the polity might cause reactions within the market domain, as when an increase in unemployment benefits induces recipients to be less vigorous in seeking new jobs. Nonetheless, any aggregate outcome is properly captured by addition across the two domains of action.

An alternative conceptualization of political economy arises once the polity is likewise recognized to be and order and not an organization. As an order, the polity has many organizations that operate within its domain; however, these organizations adjust their actions in response to one another and not in obedience to some conductor, a theme that has been articulated with especial clarity by Vincent Ostrom (1973)(1997), and whose work on this theme is surveyed in Wagner (2005).

Figure 2 illustrates this alternative theory of political economy. The market-based enterprises form a loosely connected network just as they did in Figure 1. The difference between the two figures arises in the treatment of polity, and in two distinct respects: (1) its internal organization and (2) its relationship with market-based enterprises. Polity and economy are no longer separate in Figure 2, as political and market enterprises are now commingled. Furthermore, state enterprises are no longer completely connected with one another and so do not act as a unit. The polity is not represented as an organization but as an order; it is comprised of a multitude of organization that must adjust both to one another and to the enterprises within the market economy.

Within the framework conveyed by Figure 2, polity and economy are no longer separable and additive. Political enterprises and market enterprises both comprise polycentric arrangements whose actions are mutually adjusted to one another. What results are particular relationships of cooperation and conflict between and among enterprises, both those organized within the polity and those organized within the market. Economic policy within the configuration described by Figure 2 would lack the coherence that Figure 1 would suggest it would have. Figure 1 implies that state actions would reflect a coherent plan or program, whereas Figure 2 implies that we should expect to find no more coherence from state actions than we find from market actions. For instance, market processes support both butchers and vegetarian chefs. This outcome is incoherent from the perspective of a ruling utility function, even though it is easily understandable as a product of a spontaneously generated order. Likewise, states typically pursue programs that subsidize training for new jobs while also subsidizing unemployment. Once again, these are signs of order and not of organization.

Academic discussion of the welfare state almost universally proceeds in terms of some wealth transfer from top to bottom. The reality, however, is more complex, and in a large number of ways. For instance, while minimum wage legislation generally reduces opportunities within the lower economic categories, its impact was highly varied among subsets of the population. For instance, Peter Linneman (1982) found that while the negative effects of minimum wage legislation is concentrated among the poorer parts of the income distribution, he also found those distributive effects to be quite uneven: a majority of men gained while a majority of women lost; likewise, a majority of union members gained while a majority of non-unionized people lost. Furthermore, legislators with large shares of low-income residents in their districts generally support minimum wage legislation. At first glance this seems anomalous; however, Leffler (1978) has shown that increased welfare payments more than substitute for lost income.

This simple example illustrates the point that the welfare state cannot be construed in isolation from other state activities. It also indicates that the activities of state do not reflect the coherence that we would expect a person's choices to reflect. We don't experience coherence in the pattern of market outcomes, even though we experience coherence in the choices of each individual participant. It is the same with the polity. There are many state programs that transfer income in a downward direction, but there are also many state programs that transfer income in an upward direction. Furthermore, there are many state programs that transfer income neither upwards nor downwards but sideways or obliquely.

Welfare State Redistribution within a Theory of Political Economy

The sequential framework that undergirds the conceptualization of political economy portrayed in Figure 1 is reflected in the common treatment of the welfare state as re-distributing income from its market-generated starting point. Fiscal scholarship contains a number of studies that seek to explore how much redistribution of income is achieved through political programs. These studies start with some market-generated distribution of income and ask how various state programs modify that distribution. Much of this literature has concentrated on taxation because the material has seems analytically more tractable. A nice contrast in this respect is provided by Pechman and Okner (1974) and Browning and Johnson (1979). Each study seeks to estimate the amount of redistribution that was achieved through taxation in the United States. Where Pechman and Okner claim that little redistribution was achieved, Browning and Johnson claim that there was a lot of redistribution. Most of those differences can be attributed to different assumptions about the incidence of taxation. For instance, Pechman and Okner used a methodology that made sales taxation highly regressive, whereas Browning and Johnson used a methodology by which sales taxation turned out to be pretty much equivalent to a proportional tax on income.

Any study of welfare state redistribution that limits itself to taxation is incomplete, possibly severely so. For instance, it's possible to combine a revenue system that is roughly proportional to income with a set of expenditure programs that are highly progressive in concentrating benefits toward the lower end of the income distribution. In this respect, Reynolds and Smolensky (1977) estimated that the regressive tax structure in the United States (they used the same incidence assumptions as Pechman and Okner) was more than offset by the highly progressive nature of expenditure benefits. In particular, they estimated that people in the lowest income category gained about 250 percent of their market-based income from the public sector, while people in the highest income category lost about 25 percent. To be sure, it is also possible that expenditure programs could be highly regressive. In any case, the central point is that any study of welfare state redistribution that ignores the expenditure side will give an incomplete portrait. At the same time, however, efforts to attribute expenditure incidence are more speculative and less tractable than efforts to attribute tax incidence.[2]

Differences about incidence assumptions aside, these efforts nonetheless represent a sequential and additive orientation toward political economy: first, there is a market-generated distribution of income; second, the state shifts society to an alternative distributional pattern through the subset of activities that are commonly ascribed to the welfare state; third, the end result is attained through addition across economy and polity. The relationship between polity and economy is separable and additive, which makes it reasonable to speak of a market-generated distribution of income independently of the magnitude of state-generated re-distribution. This represents sequential political economy: for there to be re-distribution through the polity there must first be distribution through the market.

While the dominant sequential orientation in political economy puts market before state, the reverse orientation is set forth cogently in Murphy and Nagel (2002), who argue that market distributions must be based on prior state actions to establish and secure property rights. While it is possible to dispute the claim that market organization is impossible without prior state action, as is done in Wagner (2007, pp. 35-36), what is most notable about this alternative treatment is that it too construes polity and economy as independent entities whose sequential actions can be added to yield a societal outcome.

Furthermore, once it is recognized that state denotes an order and not an organization, the teleological character of policy dissolves to a considerable extent and comes to resemble other products of polycentric processes. Market outcomes do not reflect the maximization of some universal utility function, and it is the same with political processes. A philosopher, or an economist, could well articulate some coherent program of mandatory health insurance. The coherence arises because it is the product of a single mind. Observations of political economy, however, reflect interaction among minds: they are observations of moving crowds and not observations of marching bands. Political economy becomes coeval and not sequential.

It is common to separate a population according to income category. This could be a three-fold separation, as illustrated by a distinction between rich, middle, and poor, or a ten-fold separation by income decile. What is particularly notable about the various studies of redistribution in this vein is their horizontal character. A society is conceptualized as containing homogeneous layers ordered by income. The number of layers is a variable of choice, with five and ten being the most common choices. Whichever number of layers is chosen, it is presumed that all people within that layer are treated identically through the redistributive programs of the welfare state.

In some respects this treatment of homogeneity within groups is dictated by desires for analytical tractability. At the same time, however, this presumption of within-group non-discrimination would seem to run afoul of some principles of coalition formation, as articulated initially by William Riker's (1962) size principle, which states that political coalitions will tend to be of minimal size so as to provide maximum gains to be divided among the members. In particular, it is doubtful that an income class provides a solid basis for a political coalition, in that there will almost always be ways of narrowing coalitions to increase the returns to the remaining members.

In illustrating this point, it will be helpful to start with George Stigler's (1970) articulation of what he called Aaron Director's law of income redistribution: the middle class gains at the expense of the upper and lower classes. Table 1 shows a simple illustration of this claim in terms of income quintiles, where the middle three quintiles comprise the middle class. This table represents some aggregation of a population into income quintiles, with the lowest quintile paying $100 per member and the highest quintile paying $500. The expenditure column shows the value placed on state services provided by the tax revenues. This shows that the middle three quintiles receive the bulk of the service benefits, which is consonant with Stigler's claim about Director. Each quintile in the middle class gains by $100 from the state's fiscal activity. The lowest quintile loses $50 and the highest quintile loses $250, because this is the quintile where most of the money is.

It is, of course, possible to develop other formulations of redistribution by income quintile. One candidate would be a coalition of the lowest three quintiles that redistribute from the highest two quintiles. What is notable about any such treatment is that coalitions are regarded comprised of groups that are homogeneous with respect to income. This treatment reflects the presumption that all members of some income class are treated identically by fiscal action. While this presumption might accord well with the norms of non-discrimination that seem second-nature to fiscal philosophers, those norms would seem to be less robust when they are inserted into the domain inhabited by political realists, and for two distinct sets of reasons: (1) its unlikely that a horizontal coalition can function effectively and (2) it's unlikely that a viable coalition would contain all members within any particular income stratum.

Why is it doubtful that a horizontal coalition can function effectively? A coalition is a form of team production and most teams require a variety of talents that would occupy different positions within the distribution of income. A successful coalition will require people with talents for thinking imaginatively and abstractly, as well as for being able to envision how to pull those talents together in some viable organization. Those talents can command a high price within the market economy. A successful coalition will also require support from people whose talents will command lower prices within the market. Among other things, people will be needed to type letters, operate phones, and make deliveries.

In short, a successful political coalition is likely to require talents that cut vertically across the income strata of a society. Whether the program of interest to that coalition deals with tobacco regulation, flood insurance, prescription drugs, or any other type of coalition, team production will be involved and this will typically call upon talents that appear at various positions within the distribution of income.

Just as it is unlikely that a coalition will be confined to a single income stratum, it is also unlikely that it will include all members of any particular stratum. For instance, national tax systems typically contain numerous provisions that, among other things, discriminate among the members of any particular income category. For instance, a coalition that seeks to promote subsidies for the production of ethanol will have participants who occupy various positions within the income distribution. Suppose hypothetically that the tax system that is initially in place is based on a comprehensive measure of income. One feature of the ethanol coalition's program may involve tax credits for people who buy cars that can be switched between running on ethanol and running on a rechargeable battery. If enacted, this tax provision will benefit a subset of people at any particular stratum within the income distribution. On average it might transfer income upward or it might transfer it downward; however, the direction of transfer is incidental to the enactment of the program.

This vertical dimension is illustrated by Table 2, which is just a disaggregate presentation of the information presented in Table 1. Table 2 presumes the society falls into three equal-sized coalitions, indicated by the groups A, B, and C. This presumption could perhaps correspond to a three-sector model of an economy, in which two of the sectors gain favored political treatment, leaving the third to bear the residual losses. Table 2 illustrates the point that the members of groups A and B gain at the expense of the members of group C, and with each group containing members from throughout the society. When the gains and losses are aggregated across the three groups, the results match what is shown in Table 1.

These two tables are, of course, constructed to make just this point and cannot therefore be used as evidence for the point. That point, of course, is that there are significant vertical dimensions to the coalitional structures of societies, and those dimensions are left out of sight by the conventional focus on broad aggregates. As a conceptual experiment, take any program that seems to involve redistribution, and ask whether it conforms to some notion of non-discriminatory state activity. By non-discriminatory, I mean state activity that would treat all people within some income quintile identically. In contrast, a discriminatory program would be one that selects only part of the members of a quintile for eligibility. Those who are selected become winners within that quintile, according to the logic of Table 2, while the others become losers.

It is surely notable that there is no such thing as one single, universal program called welfare, redistribution, or any other name. To be sure, the literature on optimal taxation is filled with such schemes to illustrate and convey conceptual points (surveyed, for instance, in Mirrlees (1994)). There, some generally applicable or universal tax is imposed and some scheme of general grants financed from the revenues. Yet nothing like this is found in actual societies. What exists instead is a complex structure of programs, each with insiders who gain and outsiders who are excluded by various eligibility requirements and standards. It makes no sense to aggregate over all those programs and to use the resulting aggregate to infer something like what Table 1 purports to show, because the very process of aggregation obscures the underlying process that is generating the observed outcomes.

In Conclusion: A Constitutional Peroration

Thomas Schelling (1978) presents a wide ranging treatment of cases where the spontaneous ordering that is generated through interaction among participants might yield emergent patterns that might not be regarded by the participants as desirable as some alternative pattern that conceivably could have been generated. How to attain superior outcomes in this setting is a difficult and knotted issue. Rather than trying to unravel the knot, it could perhaps be sliced. This is the approach of standard welfare economics, which calls for the use of state power to shift society to some alternative configuration. This approach corresponds to the sequential theory of political economy portrayed in Figure 1. In this case the political realists listen to the fiscal philosophers and implement the philosophers' program.

The coeval theory of political economy portrayed in Figure 2 offers no place for the knot to be sliced. Rather it must somehow be unraveled because there is no singular point where the insertion of power will shift the direction of movement because the polity is an emergent order and not an organization. A conductor can change the direction of the band's movement in an instant. Changing the movement of a crowd of pedestrians is a different matter; for instance, some people will climb over barricades rather than take the longer and slower path around the barricade. For emergent phenomena, the constitutional rules of the game, and the order of actions that emerge out of those rules, replaces the position of the ruler-as-conductor as the focal point for addressing issues arising out of recognition that an emergent order might have generated undesirable features.

The relation between polity and economy was central to the development of *Ordnungtheorie*, literally translated as "order theory," and which was articulated seminally by Walter Eucken (1952).[3] This theory recognized an arrangement of political economy similar to what was described by Figure 2, and sought to specify principles or rules for the conduct of state enterprises that would allow them to support rather than undermine the market economy. Ordnungstheorie was a forerunner to what has since become known as constitutional political economy.[4] The key feature of this theory is its bi-level analytical framework: the constitutional level concerns the establishment and maintenance of rules of just conduct; the operational level concerns the patterns of human activity and organization that people generate through interaction within that framework of constitutive rules.

One of the significant constitutional features of this analytical framework is expressed by the principle of market conformability. This principle would not prevent state action, but would only hold that state action should be consistent with the constitutive principles of a market economy: property, contract, and liability. With respect to the activities of the welfare state, in particular, it would be market conformable to require people to participate in programs where they contributed to accounts to support their retirement and medical care. To be sure, no constitutional rule is free from contention and controversy. The Fifth Amendment to the American Constitution is a good illustration of this. It states a simple principle clearly when it declares that private property cannot be taken by a government unless that government pays just compensation and has a genuine public use for that property. The huge volume of litigation and the intensity of the continuing controversy over takings of private property (Epstein 1985) show that mere parchment is never sufficient to maintain a constitutional framework against erosion. Yet once it is recognized that the polity also constitutes a spontaneously generated order, the constitutional framework for a coeval political economy becomes the proper arena for addressing issues that arise from what might appear to be undesirable though emergent features of that order.

Table 1: Hypothetical Redistribution, Aggregated by Quintile

Quintile	Tax Paid	Value Received	Net Gain
Lowest	100	50	- 50
Second	200	300	100
Third	300	400	100
Fourth	400	500	100
Highest	500	250	-250

Table 2: Hypothetical Redistribution, Disaggregated within Quintiles

Quintile	Net Gain, Group A	Net Gain, Group B	Net Gain, Group C	Aggregate Net Gain
Lowest	20	20	- 90	- 50
Second	140	140	- 80	100
Third	160	160	- 120	100
Fourth	180	180	- 160	100
Highest	200	200	- 1150	-250

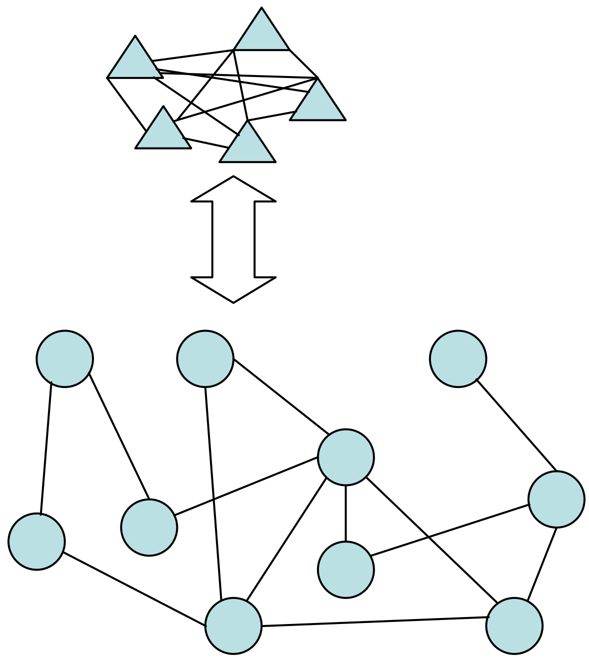
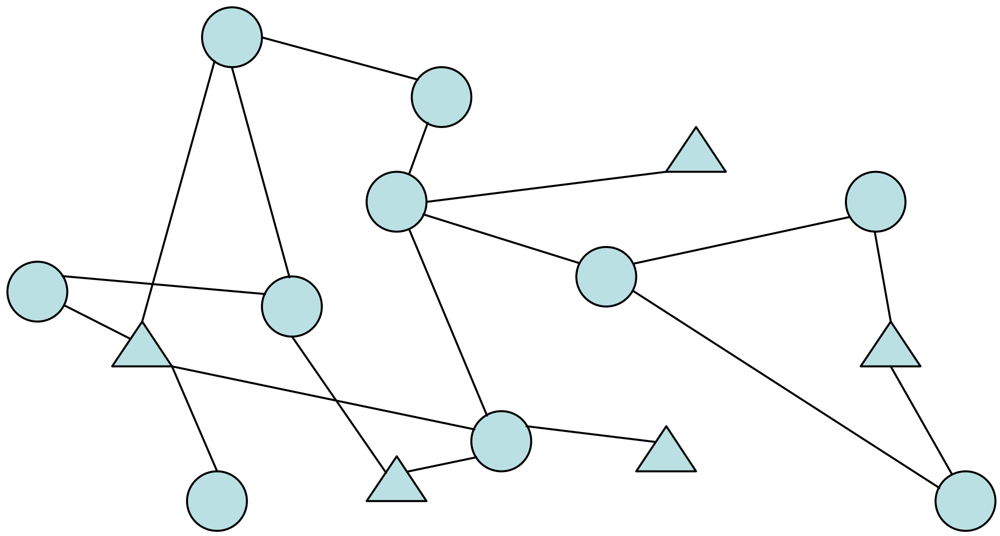


Figure 1: Political Economy with State as Organization



Market-based Enterprises

State-based Enterprises

Figure 2: Political Economy with State as Order

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Endnotes

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[2] In light of the general substitutability between budgetary operations and regulations noted above, even studies of redistribution through budgets might give an incomplete portrait of welfare state redistribution.

[3] For a collection of essays on Eucken-like themes, see Leipold and Pies (2000). For a textbook statement of this theme in English, see Kaspar and Streit (1998).

[4] For a crisp statement of central themes, see Buchanan (1990). For an examination of the relationship between constitutional political economy and the Eucken-inspired theory of order, see Vanberg (1988). For a recent survey of constitutional political economy, see Brennan and Eusepi (2004).